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THE GENERAL ACCOUNTING OFFICE AUDIT OF THE FEDERAL HOUSING ADMINISTRATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND URBAN AFFAIRS

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

THE RESULTS OF THE 1988 FINANCIAL STATEMENT AUDIT OF THE FEDERAL HOUSING ADMINISTRATION

SEPTEMBER 27, 1989

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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THE GENERAL ACCOUNTING OFFICE [GAO] AUDIT OF THE FEDERAL HOUSING ADMINISTRATION [FHA]

WEDNESDAY, SEPTEMBER 27, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND URBAN AFFAIRS,
Washington, DC.

The subcommittee met at 10 a.m. in room SD–538 of the Dirksen Senate Office Building, Senator Alan Cranston (chairman of the subcommittee) presiding.

Present: Senators Cranston, Riegle, Sanford, D'Amato, Garn, and Pressler.

OPENING STATEMENT OF SENATOR CRANSTON

Senator CRANSTON. The hearing will please come to order.

I welcome all of you. This is the third in a series of important hearings on the financial condition of the Federal Housing Administration.

At the first hearing, Comptroller General Charles Bowsher and Mr. Thomas Craren of Price Waterhouse gave a preliminary report on the massive, 2-year effort to audit FHA's financial statements. In the second hearing, FHA Commissioner Austin Fitts testified about the Bush administration's plans to deal with FHA problems.

Those witnesses are here this morning to examine new information about FHA's financial health.

The subcommittee is preparing for three additional hearings on FHA. One will hear the response of private experts to the information being released this morning; a second will consider legislative action to correct problems in the FHA coinsurance program; and a third will consider immediate steps to protect the long-term soundness of FHA insurance for single-family homes.

This morning's hearing is the keystone of the series. The testimony we are about to hear is long awaited. It is the product of 2 years of intensive work by a team of accountants from GAO and Price Waterhouse. It is a consolidated statement of FHA's financial position using generally accepted accounting principles. It is the first such statement ever provided to Congress. And it is a blockbuster.

You will hear the most devastating evidence yet about the enormity of the mess that the Reagan administration left behind at HUD.

The damage to the FHA is particularly troubling. The FHA is a central pillar of Federal support for affordable home finance. FHA

provides mortgage insurance for over 600,000 families a year. The overwhelming majority of them are families with moderate or middle incomes. Many of them are families who have struggled to buy their first home.

FHA is vital to the development of low income rental housing.

And FHA provides important stability to the private mortgage lending system. In many areas of the country, particularly when times are tough, FHA is often the only source of mortgage insurance.

The mission of FHA is among the most complex in Government. FHA has to manage risk; it has to collect and disburse large volumes of funds; and it has to manage and sell thousands of properties. It has to serve thousands of local housing markets. It has to respond to cycles in the national and regional economies. It has to protect against the constant possibility of fraud and abuse. And it has to adapt to revolutionary changes in mortgage finance.

FHA therefore deserves dedicated, competent management. Instead, in recent years, FHA was dumped in the hands of its enemies.

The need for sweeping reform of FHA has been recognized for years. Twelve years ago, this committee held major hearings on the "Future of FHA." Witnesses called for dramatic improvements in FHA that still have not been made.

Shortly after the Reagan administration took office in 1981, housing leaders went to top officials in the new administration and presented a number of key ideas for making needed reforms at FHA. They were told bluntly, "We are not really interested in reforming FHA, we want to kill FHA."

And that was the tone for 8 long years. An early Reagan goal was to phase out FHA within 4 years. Later, a scheme was floated for selling FHA off. Under the banner of "privatization," large powers were delegated to the private sector with little concern for adequate monitoring. Staff was slashed by one-third and demoralized.

Those 8 long years of mismanagement, neglect, abuse, and hostility produced a bitter harvest that we now are beginning to reap.

Huge losses have resulted from such factors as economic distress in the oil producing States, large scale fraud in the coinsurance program, incompetent management, and poor financial accounting and control practices that were allowed to fester year after year.

It has been impossible to assess FHA's financial position. The inadequacies of FHA's accounting system have not permitted GAO to conduct a satisfactory audit since 1974. The problems became so severe that GAO was forced to terminate its attempts to audit FHA in 1981 and 1984.

One of the disturbing facts of this major new audit is that after 2 years of work GAO and Price Waterhouse are still not able to give assurance that these financial statements fairly present the financial position of FHA.

This morning you will hear that the potential losses are enormous.

Damage was done to the Mutual Mortgage Insurance Fund. That is the main insurance fund for homeowners, a fund that is designed to be self-sustaining. GAO will show that the fund lost $1.4 billion

in fiscal year 1988, after taking account of expected losses from defaults. In only 1 year, the fund's equity fell from $3.4 billion to $1.8 billion.

You will hear that the General Insurance Fund, the principal source of insurance for low income and moderate income rental housing, lost almost twice as much—a loss of $2.6 billion in 1 year.

Total FHA losses for the year were $4.2 billion, driving Government equity from a positive $1.2 billion at the end of fiscal year 1987 to a negative $2.9 billion at the end of fiscal 1988.

While this was going on, the Reagan administration was painting a relatively rosy picture. It reported that, for fiscal year 1988, the FHA lost less than $860 million and had positive equity of almost $2 billion.

We have been hearing that the problems at HUD were caused by mismanagement and incompetence. But now this multibillion dollar disparity in financial reporting raises a serious question of whether there was a deliberate coverup of a major disaster. It raises a question of whether leaders at HUD were intentionally cooking the books.

This subcommittee will seek a thorough and objective assessment of FHA's condition. And we will not stop until we have remedies for FHA's problems.

We will probe the full extent of problems at FHA. We need to understand how this could have happened.

We will explore the degree to which program flaws or management failures affect the long-term integrity of the FHA fund.

We will determine what must be done to stem the losses and guarantee that FHA remains sound for the long term.

We will pursue any legislative remedies that are necessary to make FHA a strong and responsive institution that is able to serve the housing needs of future generations in all parts of this country as magnificently as it served the needs of the American people years ago. I will be satisfied with nothing less.

Our witnesses this morning bring important, though disturbing news. I commend GAO and Price Waterhouse for a very difficult task well done. I expect that this report will be an invaluable starting point for the great work that remains ahead. I am eager to hear your testimony and your recommendations for remedial action.

Before proceeding to the witnesses, I ask Mr. D'Amato if he has opening remarks.

Senator D'AMATO. I am interested in hearing and getting the facts from the GAO. I am going to ask that my statement be submitted for the record as if read in its entirety.

Senator CRANSTON. It will appear in the record in full.

[The complete prepared statements of Senators D'Amato and Sanford follow:]

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I'd like to thank Price Waterhouse and the people at GAO for responding as quickly as they could with the results of their joint study of the FHA funds.

It is obvious that two of the funds, the General Insurance Fund and the Special Risk Insurance Fund, have sustained particularly heavy losses over the past few years. Some drastic changes need to be put in place so that future losses in the programs do not exceed what can reasonably be expected of subsidized programs, and the premiums paid into those insurance funds. I look forward to hearing Mr. Bowsher's testimony on the improvements he sees as necessary due to the results of the GAO/Price Waterhouse study.

Also, I am very interested to hear what Assistant Secretary Fitts has to say about the results of the study, as well as the safety control measures currently in place at FHA and those planned for the future to avoid further losses.

The FHA program provides a valuable commodity to low- and moderate-income Americans, particularly first-time homebuyers. We cannot jeopardize this program with faulty management. The focus of the professionals at FHA should not be clean-up of the past problems, but helping the average American realize the dream of homeownership.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman. I appreciate your efforts in pulling together this hearing and want to thank our distinguished witnesses for their work in examining the financial condition of FHA.

I joined my colleagues in reading with concern the various articles that have appeared in the press recounting the findings of the GAO and others that the FHA program may this year suffer its second consecutive loss; that reserves for the program have dwindled to $2.8 billion to support $277 billion in outstanding insured mortgages; and that losses are mounting at the rate of $40 billion a month. I understand that this hearing may bring out additional bad news.

Many of these losses are attributable to economic downturns, especially in the Southwest, and a sluggish housing market, which has cut premium income. But unfortunately, reports here again point to fraud and loose management during the last 8 years as a significant part of the problem as well. I am also disturbed that GAO was unable to conduct full financial statement audits of FHA since 1975 due to accounting and internal control deficiencies.

I know I share the concern of many of my colleagues that have spent countless hours and considerable energy grappling with finding the right solution to the crisis facing the FSLIC. The last thing any of us would want is to face the taxpayers with news that another government program—the FHA program—is in financial trouble. To avoid this travesty, we must take seriously our obligation to examine carefully the FHA and Ginnie Mae and related programs to ensure their fiscal soundness.

If proposals to raise the FHA lending limits and lower the downpayment requirements are to be considered, we must have an accurate analysis of what additional risks, if any, such changes place on the FHA. We must determine whether the financial condition of the FHA is such that it can absorb any additional risk that we may

choose, for public policy reasons, to place on the FHA. We must also consider the affect of FHA structural changes on the secondary markets, the private insurance industry, and the Savings and Loan industry.

Last week in the Senate we had a lengthy debate on the validity of raising FHA loan limits to 95 percent of state median in high cost areas. The financial stability of the FHA was at issue in that debate, and this hearing will provide substantive data to help the Senate make an informed decision in the future.

Last week's debate left me in the untenable position of either supporting substantial increases to loan limits, or restricting the increase in loan limits while reducing the number of new positions within HUD management and administration. Given that the serious problems in HUD have been substantially related to an absence of auditors and mangement personnel, I could not vote for amendments that would reduce budget for HUD management and administration salaries. However, I would like to go on record as opposing substantial loan limit increases that are not either connected to higher loan-to-value ratios for FHA loans or targeted to income. The fiscal strength of FHA must be the primary consideration as we consider structural changes to FHA programs. That is why this hearing is so critical.

I am pleased that Secretary Kemp has stated his determination to institute needed reforms of FHA in order to determine the true fiscal status of the Insurance Funds, improve financial management, restore effective accounting procedures, and reinvigorate FHA to serve as a cornerstone of Federal housing policy. The past failures in FHA management and accountability must yield to a vigorous reform effort that reestablishes the financial strength of FHA programs.

I would also like to commend the Housing Subcommittee, and in particular Senator Cranston, for his commitment to FHA reform and for his tireless efforts on behalf of Federal housing programs. His leadership is essential to the process of enabling HUD to fulfill its mission of housing low- and moderate-income individuals.

I hope that this hearing will help us to come to a greater understanding of the problems the FHA faces and what steps, if any, need to be taken to ensure that the FHA remains in perfectly sound condition.

Thank you Mr. Chairman.

Senator CRANSTON. Senator Garn.

OPENING COMMENTS OF SENATOR GARN

Senator GARN. Unfortunately, I have two committees going on at the same time. So I will not be able to stay, but I certainly will review your testimony because we just spent the entire summer spending the taxpayers' hard-earned dollars on the savings and loan crisis, and this Senator certainly does not plan to be involved in the Banking Committee finding itself in a position where it must once again bail out an insurance fund of the Federal Government that was abused or mismanaged.

Certainly, FHA historically has served as a very valuable and useful tool in helping families and other first-time home buyers re-

alize their dream of getting into a home, but we obviously must keep FHA on the track that they were intended to be on; that is, insuring mortgages without endangering the FHA fund.

So I thank all of you for coming and do apologize again for having to go to these markups.

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you very much.

We will now hear from our first witness, Charles A. Bowsher, Comptroller General, U.S. General Accounting Office.

We welcome you and we thank you for the very fine work you have undertaken.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY JOHN M. OLS, JR., DIRECTOR, HOUSING AND COMMUNITY DEVELOPMENT ISSUES RESOURCES, COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION, GENERAL ACCOUNTING OFFICE; DENNIS J. DUQUETTE, DIRECTOR, AGENCY FINANCIAL AUDITS, ACCOUNTING AND MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE; AND THOMAS CRAREN, PARTNER, PRICE WATERHOUSE, OFFICE OF GOVERNMENT SERVICES, WASHINGTON, DC

Mr. BOWSHER. Thank you very much, Mr. Chairman and Senator D'Amato.

I thought I would read the first two pages of summary of the entire financial situation and then summarize the balance of my statement, and then we will be more than pleased to take questions.

We are very pleased to appear today to discuss the results of the 1988 financial statement audit of the Federal Housing Administration. On August 1, 1989, I appeared before this subcommittee and presented testimony on the history of our financial statement audits at FHA. At that time I stated that we had contracted with the independent certified public accounting firm of Price Waterhouse to assist us in auditing FHA's financial statements for fiscal year 1988.

The fiscal year 1988 financial audit has just been completed. FHA's financial statements show losses of $4.2 billion in fiscal year 1988 and that the Government's equity sunk to a deficit of $2.9 billion at the end of the fiscal year. The information provided by that audit gives cause for substantial concern.

In summary, FHA's Mutual Mortgage Insurance Fund, its largest fund, incurred a loss of $1.4 billion in 1988, causing its equity to diminish to $1.8 billion.

And FHA's General Insurance Fund, its second largest fund, incurred a loss of $2.6 billion in 1988, causing its already negative equity to further deteriorate to a deficit of $3.1 billion, even after an appropriation of $300 million.

The GI Fund situation is particularly troubling because of basic weaknesses in the coinsurance program and the potential for defaults in the hospital mortgage insurance program. It is clear that substantial appropriations will be needed to restore the solvency of the GI Fund.

Basic management weaknesses must be corrected if future losses are to be brought under control. The audit disclosed several problem areas:

There has been a lack of effective monitoring of those program activities delegated to the private sector.

Financial information needed to properly manage FHA's programs has not been available.

Important internal controls are not effective, particularly with regard to cash management and the processing of multifamily insurance claims.

Essential accounting functions have not been performed adequately.

And management has not been diligent in correcting the weaknesses identified in earlier reviews.

We and Price Waterhouse are unable to express an opinion on FHA's financial statements. There are uncertainties over the amount of losses that may result from, one, the extent of the diversion of property sales proceeds, two, the extent to which foreclosed property reflected in FHA's financial statements may be misstated, and, three, the effect that the outcome of other investigations might have on FHA's financial statements.

Numerous investigations of alleged fraud, embezzlement, and other illegal acts are currently underway and it is not possible to determine the extent of losses that could ultimately be sustained by FHA as a result of these alleged improprieties. As a result, the losses may be greater than those reported in the financial statements.

Now, if I could direct your attention to the chart. It is also in your statement at page 26 for the people in the room that cannot see the chart.

I would like again to remind everybody we have two self-sustaining funds here.

The MMI Fund, the Mutual Mortgage Insurance Fund, provides the basic single family mortgage insurance, and then you have the Cooperative Management Housing Insurance Fund, which is also a mutual fund, that provides mortgage insurance to finance the purchase, construction, and/or rehabilitation of multifamily-cooperative housing property. Also insured under this fund are supplementary loans that finance improvements or repairs of multifamily cooperative housing properties or that provide funds for necessary community facilities.

And then we have two funds that are subsidized. The first and the largest is the General Insurance Fund, which provides for a large number of specialized mortgage insurance programs, including insurance of loans for property improvements as well as for cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities, and nonprofit hospitals.

And then the last is the Special Risk Insurance Fund that provides mortgage insurance for high risk mortgages who normally would not be eligible for mortgage insurance, including mortgages covering property in older and declining urban areas.

Now, if I could just point out, at the bottom of the chart you have—you can see still $1.8 billion of positive Government equity in the MMI Fund. It is really in the subsidized funds, the GI Fund

and the SRI Fund, where we are now in a negative position. We were in a negative position, and what we have done here, of course, is we have added to the negative position.

Now, why the losses?

If we go back to the MMI Fund, the biggest thing that happened was the increase in the number of defaults. We have gone from 166,000 defaults in 1987 to 203,000 in 1988, and when you price those out at an average of 24,000 a case, that is really the bulk of the large loss that had to be booked here in 1988. Much of the defaults are happening in the economic distressed areas, which is the oil patch areas. You also, of course, have some higher losses on the foreclosed property than historically was being incurred.

So that is basically what is causing our problem in the MMI Fund.

In the GI Fund, where we had a loss of $2.6 billion, one of the biggest factors was in the multifamily insurance program. This is a coinsurance program where the coinsurers are supposed to cover up to 20 percent of the insurance risk and the Government to assume 80 percent. It was in this program that DRG, the second largest coinsurer, went into default in September 1988, and because it was so thinly capitalized they were not able to bear the 20 percent, and so the FHA is going to have to bear practically 100 percent of the loss. We also had two other coinsurance firms default this year. These large defaults are adding up to close to $1 billion for this fund.

I think later on we will probably talk more about it, but one of the problems that worries us for the future is that you have a very high concentration in this program area. Five of the largest firms have over 70 percent of the business, and the issue of capitalization, adequate capitalization, I think is an important point.

Another area here that contributed to the problem in this fund, the GI Fund, was the defaults of the FHA-insured hospital mortgages of $275 million.

Now, if I could again just reiterate what we think are the major factors causing the problems here. I would start off by saying monitoring what is happening out there is absolutely essential when you delegate some of the program authority to the private sector, and that is what we have done in recent years. If I could read just three points from page 9.

It says here:

We noted deficiencies in the following broad categories of functions delegated to third parties:

One, HUD's delegation of authority to certain eligible lenders to underwrite FHA mortgage insurance, particularly single family mortgage insurance.

Two, HUD's delegation of authority to area management brokers to maintain, manage, and sell properties that FHA obtained in foreclosure.

And, three, HUD's delegation of authority to private closing agents to handle the collection of property sale proceeds, including their deposit in HUD's account at the U.S. Treasury. Marilyn Harrell, who has become known as "Robin HUD," was one of these private closing agents.

If you are going to delegate this kind of work to third parties, then what is important is to have adequate monitoring. We feel that HUD has not had adequate monitoring in recent years.

You also need a trained staff, and you need adequate numbers of trained staff. For example, one broker was allowed to manage over 1,000 properties, well in excess of the HUD-mandated limit of 100.

The third major concern we have had is the financial information. You have got to know when you are in trouble and where and how much, and so we looked at the financial systems of HUD and FHA, and, of course, we found them lacking.

One thing we noticed is that you have some overlapping systems that do not give adequate and accurate information, and so we have a redundant effort, not too different than what we saw in New York City 14, 15 years ago.

The internal controls.

Well, the Federal Managers' Financial Integrity Act reports indicated problems here in these programs, and although action was promised, not much action was achieved.

And then you get down to the basic accounting, where you expect to see the documentation supporting the account balances, and here we often saw that documentation as being missing or inadequate.

Reconciliation of your general ledger accounts. They were not performed often and, if done, were often done on an untimely basis.

And then I think we had the lack of proper support for some payments. This made the audit difficult, and it certainly made it difficult for HUD management to know what was happening.

I have already mentioned the excessive concentration in the coinsurance program. I think if you look at the chart right behind attachment 1, which is attachment 2, you will see that the coinsurers are heavily concentrated in five large firms. Also, the issue of capitalization is crucial.

Now, if I could, Mr. Chairman, I would like to give you some good news. On page 21 we do point out that the new Secretary, Secretary Kemp, is anxious to do the right thing. He has put together a fine team. I see Austin Fitts is with us here today, and I think she and the others on the team are first rate people in experience and capability. We are very hopeful that many of HUD's problems are going to be addressed in the next few months and few years.

We have tried to summarize on the chart over there the actions we believe need to be addressed. One is to develop a management action plan with milestones that corrects reported weaknesses and achieves adequate monitoring of FHA's operations. We also recommend strongly the evaluation of coinsurance capitalization requirements because we don't think that the Government should have to stand for all of the losses in these situations, and that is the risk we are taking when coinsurance firms are undercapitalized.

I think we need the Chief Financial Officer at HUD and the Comptroller at FHA to monitor the action plan, to set the accounting and financial reporting policies, to oversee the financial management systems, and to develop adequate internal controls. We strongly urge the issuance of an annual audited financial statement. And truly we think that the congressional oversight needs to be improved.

I think this is true of congressional oversight in general on many programs, and I intend to meet with many of the committees in the next several months, looking at what I call an annual report from the Secretary of the Department as to how the programs are working and to bring in the annual financial audit and the annual statement on where they stand on internal controls, which is required by the Federal Managers' Financial Integrity Act.

I think it is awfully important that Congress hold an annual oversight hearing and hear from the head of the agency as to what the problems are, what is being done about the problems, what progress is being made, and what has yet to be accomplished.

I think if that could be done on an annual basis, the Congress would be in much better shape to know what is going on, and it would force the Executive Branch to monitor what progress they are making.

Mr. Chairman and members of the committee, that completes the summary of my statement, and I would be happy to answer any questions. We would appreciate it if the statement in total would be put in the record.

[The complete prepared statement of Charles A. Bowsher follows:]

United States General Accounting Office

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1988 Financial Audit: Federal Housing Administration

Statement of
Charles A. Bowsher
Comptroller General of the United States

Before the
Subcommittee on Housing and Urban Affairs
Committee on Banking, Housing and Urban Affairs
U.S. Senate

GAO/T-AFMD-89-17

GAO Form 160 (12/87)

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear today to discuss the results of the 1988 financial statement audit of the Federal Housing Administration (FHA). On August 1, 1989, I appeared before this subcommittee and presented testimony on the history of our financial statement audits at FHA. At that time, I stated that we had contracted with the independent certified public accounting firm of Price Waterhouse to assist us in auditing FHA's financial statements for fiscal year 1988.

The fiscal year 1988 financial audit has just been completed. FHA's financial statements show losses of $4.2 billion in fiscal year 1988 and that the government's equity sunk to a deficit of $2.9 billion at the end of the fiscal year. The information provided by that audit gives cause for substantial concern. In summary,

-- FHA's Mutual Mortgage Insurance Fund, its largest fund, incurred a loss of $1.4 billion in 1988, causing its equity to diminish to $1.8 billion, and

-- FHA's General Insurance Fund, its second largest fund, incurred a loss of $2.6 billion in 1988, causing its already negative equity to further deteriorate to a deficit of $3.1 billion, even after an appropriation of $300 million.

The GI Fund situation is particularly troubling because of basic weaknesses in the coinsurance program and the potential for defaults in the hospital mortgage insurance program. It is clear that substantial appropriations will be needed to restore the solvency of the GI Fund.

Basic management weaknesses must be corrected if future losses are to be brought under control. The audit disclosed several problem areas:

-- There has been a lack of effective monitoring of those program activities delegated to the private sector,

-- Financial information needed to properly manage FHA's programs has not been available,

-- Important internal controls are not effective, particularly with regard to cash management and the processing of multifamily insurance claims,

-- Essential accounting functions have not been performed adequately, and

-- Management has not been diligent in correcting the weaknesses identified in earlier reviews.

We are unable to express an opinion on FHA's financial statements. There are uncertainties over the amount of losses that may result from (1) the extent of the diversion of property sales proceeds, (2) the extent to which foreclosed property reflected in FHA's financial statements may be misstated, and (3) the effect that the outcome of other investigations might have on FHA's financial statements. Numerous investigations of alleged fraud, embezzlement, and other illegal acts are currently underway and it is not possible to determine the extent of losses that could ultimately be sustained by FHA as a result of these alleged improprieties. As a result, the losses may be greater than those reported in the financial statements. (See attachment III)

Before I get into the details of the financial statement audit, let me spend a few minutes discussing some background related to FHA.

BACKGROUND

FHA was established in 1934 under authority granted to the President by the National Housing Act (Public Law 73-479). In 1948, FHA became a wholly owned government corporation subject to the Government Corporation Control Act, as amended. FHA and its functions were transferred to the Department of Housing and Urban Development (HUD) in 1965. After the transfer, FHA no longer had separate staff or facilities; its operations have been conducted, along with other housing activities, by HUD organizations.

The basic purpose of FHA programs is to encourage improvement in housing standards and conditions, provide an adequate home financing system through mortgage insurance, and exert a stabilizing influence on the mortgage market. To carry out this purpose, the Secretary of HUD administers FHA through four separate funds for its various mortgage insurance programs -- the Mutual Mortgage Insurance (MMI) Fund, the Cooperative Management Housing Insurance (CMHI) Fund, the General Insurance (GI) Fund, and the Special Risk Insurance (SRI) Fund.

FHA'S 1988 FINANCIAL STATEMENTS

As I have already stated, FHA, with $303 billion of insurance in force, lost $4.2 billion in fiscal year 1988, thereby converting the government's equity in FHA from a surplus at the beginning of fiscal year 1988, to a deficit of $2.9 billion at the end of fiscal year 1988. The majority of losses occurred in the MMI and GI Funds--FHA's two largest.

As shown in Attachment I to this statement, the MMI Fund, FHA's largest fund with $229 billion of insurance in force as of September 30, 1988, had a loss of $1.4 billion in fiscal year 1988. This loss caused the government's equity in this fund to fall to $1.8 billion at the end of the fiscal year. The MMI Fund provides basic single family mortgage insurance and is intended to be self-sustaining.

In addition, the General Insurance (GI) Fund, FHA's second largest fund, with $62 billion of insurance in force as of September 30, 1988, had a loss of $2.6 billion in fiscal year 1988, causing the government's already negative equity position in this fund to fall to a deficit of $3.1 billion at the end of the fiscal year. The GI Fund provides insurance on loans for cooperatives, condominiums, housing for the elderly, and non-profit hospitals, and is subsidized by appropriations to restore certain losses sustained from its mortgage insurance operations.

Let's look at why these funds are losing money.

Mutual Mortgage Insurance Fund

The $1.4 billion loss in the MMI Fund for fiscal year 1988 is mainly attributable to a $1.2 billion increase in its loss reserves. These reserves are necessary to account for losses on defaults which will eventually lead to claims.

Two major factors contribute to the MMI Fund's increase in loss reserves. First, the record high single family mortgage insurance endorsements from 1986 and 1987 are entering their historically high claim period and thus defaults have remained at a high level. Like many private mortgage insurers, FHA, and particularly the MMI Fund, experiences its highest rate of claims in the second and third year after the insurance is written. The rate gradually decreases after

the third year and levels off after the tenth year of the policy. Given the significant level of insurance written by the MMI Fund in 1986 and 1987, defaults are likely to continue at a relatively high level, at least in the near term.

The other factor contributing to the increase in loss reserves in the MMI Fund is the persistently high default and foreclosure rates in economically stressed regions, particularly the Rocky Mountain and Southwest regions. While the percentage of insurance written in these regions to total MMI insurance in force has remained relatively stable, claim rates, and thus losses, have been substantial in these stressed regions.

The MMI Fund's results were also affected by increasing losses when foreclosed property was eventually sold. While some losses on the sale of foreclosed properties should be expected, losses in distressed regions, particularly the Rocky Mountains, increased by 10 percent.

General Insurance Fund

The $2.6 billion loss in the GI Fund for fiscal year 1988 is mainly attributable to a $2.1 billion increase in its loss reserves. The GI Fund's premium and other revenues are not sufficient to cover its losses, leaving it dependent on Treasury borrowings and appropriations to offset the losses.

Loss reserves in the GI Fund increased significantly during 1988 because of defaults in the Fund's multifamily coinsurance programs and, to a lesser degree, because of potential defaults of FHA insured hospital mortgages. Under the multifamily coinsurance programs, eligible lenders/coinsurers perform underwriting, servicing, management, and property disposition functions and assume responsibility for a portion of any insurance loss (up to a maximum of approximately 20 percent the loan).

In September 1988, DRG Funding Corp., a major FHA lender/coinsurer, was declared in default of its obligations. Subsequent to September 1988, two more large FHA lender/coinsurers were declared in default. Substantially all the losses will be borne by FHA. A loss provision of $960 million has been recorded in 1988 for estimated losses resulting from these and other probable defaults in the multifamily coinsurance programs. Because of basic weaknesses in the multifamily coinsurance programs, involving inadequate levels of capital and deficient coinsurer monitoring, it is possible that still more coinsurer defaults may occur and cause additional losses of unknown magnitude.

Another factor contributing to the increase in loss reserves in the GI Fund relates to probable defaults of FHA-insured hospital mortgages. A provision of $275 million has been recorded for these probable defaults. Changes in external conditions which affect occupancy rates are partially responsible for defaults of these

mortgages and could cause additional defaults in the future. Even a few defaults of these large mortgages could place a serious financial burden on the GI Fund.

Actuarial Soundness

HUD's actuary has determined that the MMI Fund's future income will exceed future expenses for insurance in force as of September 30, 1988. Nevertheless, we are studying other aspects of the MMI Fund to determine whether there are fundamental weaknesses that must be addressed.

HUD's actuary has determined that, in the aggregate, the GI Fund's premiums are insufficient to cover its losses and the Fund is dependent on borrowings from the U.S. Treasury and appropriations to sustain its operations.

FINANCIAL MANAGEMENT PROBLEMS

The audit noted a number of financial management problems that HUD and FHA top management need to address. These are the same fundamental accounting and financial management problems that GAO and the Inspector General have been reporting on since the early 1980s.

Monitoring Needs to be More Effective

In terms of its direct effect on FHA's financial condition, the most critical weakness was in HUD's monitoring of functions involving large amounts of money delegated to third parties.

We noted deficiencies in the following broad categories of functions delegated to third parties:

1. HUD's delegation of authority to certain eligible lenders to underwrite FHA mortgage insurance, particularly single family mortgage insurance.

2. HUD's delegation of authority to Area Management Brokers to maintain, manage and sell properties that FHA obtained in foreclosure.

3. HUD's delegation of authority to private closing agents to handle the collection of property sale proceeds, including their deposit in HUD's account at the U.S. Treasury. Marilyn Harrell, who has become known as "Robin HUD," was one of these private closing agent.

Oversight of the private underwriters suffered from a lack of coordination between the various parts of HUD that have information important to the oversight functions. Also, there's a lack of up-to-

date default information to identify the causes of excessive insurance losses.

Oversight of Area Management Brokers and private closing agents suffered, at least partially, from a lack of experienced staff to handle the large number of foreclosed properties that came to HUD in economically stressed regions. For example because of a lack of oversight one broker was allowed to manage over 1,000 properties, well in excess of the HUD-mandated limit of 100. Allowing brokers to manage excessive numbers of properties exposes FHA to excessive losses should one or more of the large brokers decide not to follow HUD rules.

Better Financial Management Systems Needed

Many of FHA's problems can be attributed to not having accurate financial information that is needed to properly manage FHA's programs.

For example, at present, managers at FHA do not have sufficient program level financial information to determine which programs are self-sustaining and which are not. FHA's four major funds encompass over 40 programs, each with its own unique purpose and each with unique financial attributes. Financial information is periodically produced only for each of its four major funds. FHA, therefore, does not have accurate information to promptly determine financial

results on a program-by-program or region-by-region basis; losses can only be attributed to major activities and cannot be pinpointed with any degree of precision to a particular program or region. This lack of adequate information prevents identifying the causes for losses, such as whether excessive losses are caused by external conditions or by mismanagement.

Another example of the lack of proper financial information is the use of different, overlapping systems used by the groups administering the programs and the groups performing finance and accounting functions. For example, two separate systems are currently used to manage and account for FHA-owned foreclosed properties - one by the office of housing and another by the office of finance and administration. Apart from the complexities and redundancy introduced by using two systems to perform similar functions, the system used by the office of housing, the group responsible for property management and sale, only contains information on the number of properties but no dollar information. The two systems routinely show large differences in the number of properties FHA owns at any given time, and only recently have attempts been made to explain these differences. Collectively, the problems with the property systems cause uncertainties about the number and dollar value of the properties FHA actually owns and raises questions about how property can be properly managed and sold with questionable information about its value.

Internal Controls Need to be Improved

HUD's internal controls over cash management and claims processing are weak and require improvement. HUD has not done enough, through the use of its own systems, to ensure that proceeds collected by third parties are promptly deposited in FHA's Treasury account, and that claims for insurance benefits are being paid timely and only after proper review and examination.

HUD has followed the policy of accepting sales packages and of recording sales before sales proceeds are actually deposited in its Treasury account. Follow-up of case-by-case situations where sales have been processed but where no cash has been received has been inconsistent across regions. Indeed, reports of sales for which proceeds have not yet been located contain over 8,000 cases, some dating back to 1983. One region, in particular, was so deficient in this regard that a private closing agent ("Robin HUD") has admitted to embezzling a sizable amount of sale proceeds without prompt detection.

Our review of HUD's multifamily claim payments process showed that HUD has a large backlog of claim cases where the mortgagee has complied with all HUD requirements but which have simply not been paid because of delays in final processing. We estimate that HUD has incurred additional interest costs ranging from $6 million to $10

million as a result of these delays.

In addition, HUD does not verify all financial data provided in mortgagee claim submissions. For example, in one instance where a mortgagee failed to disclose information about a special escrow account when submitting a claim for payment, the claim examiner did not verify the escrow account balance and reduce the claim accordingly. As a result, the claim was overpaid by some $2.8 million.

Better Performance of Accounting Functions Needed

Any operation the size of FHA has a number of routine accounting functions that must be continually performed to ensure that financial statements and other financial reports are accurately produced. Routine accounting functions include very basic procedures -- reconciling accounts to supporting records, diligent record keeping, controlling funds held on behalf of others, and making sure transactions are properly recorded. HUD staff have been deficient in performing these very basic routine accounting functions:

-- Documentation supporting several account balances was missing or incomplete.

-- Reconciliations of general ledger balances to supporting

records were not performed timely, and in many cases not at all.

-- Some payments were made without proper support or justification.

-- Forbearance agreements, agreements which restructure the terms of defaulted mortgages in the interest of providing some sort of work out, were not properly recorded in the loan system.

-- Escrow accounts maintained by HUD to fund repairs on HUD owned properties were not properly accounted for.

More Diligent Follow-Up of Findings Needed

HUD has not been diligent in correcting problems cited by auditors or in its own Federal Managers' Financial Integrity Act (FMFIA) reports. While HUD staff responsible for FHA activities have generally responded to recommendations by GAO and the Inspector General and the weaknesses disclosed in the FMFIA reports, resolution of the findings has often been delayed and some findings are not addressed at all. In addition, in some cases, there are no follow-up reviews to determine if proposed procedures in fact cured the cited problems.

For example, HUD's 1987 FMFIA report disclosed that inadequate controls existed which provided the potential for private closing agents to manipulate or otherwise take funds for their own use or to delay the transfer of such funds to HUD. However, this same weakness was noted during the 1988 audit. The lack of follow-up and implementation unnecessarily exposes FHA to the risk of waste, loss, unauthorized use, or misappropriation of government funds, property, and other assets.

EXCESSIVE CONCENTRATION AND INADEQUATE CAPITAL REQUIREMENTS IN THE COINSURANCE PROGRAM

FHA's multifamily coinsurance programs incurred significant losses during 1988. We have a number of concerns about how these programs are structured and administered. Our concerns relate to whether the levels of capital required of coinsuring lenders are sufficient, and whether the controls designed to reduce portfolio risk and to monitor coinsuring lenders are effective.

Under the multifamily coinsurance programs, various loan functions are delegated to eligible lenders including underwriting, servicing, management and property disposition functions. The lenders then coinsure approximately 20 percent of the mortgage amount, thereby assuming responsibility for a portion of any insurance losses resulting from defaulted mortgages. If there is

also an absence of adequate surveillance and monitoring, as we found to be the case, there is a temptation to grow without regard to the quality of that growth.

Under FHA's present capital requirements, one large coinsurer, before it defaulted, had capital of about $5 million in relation to its coinsured portion of $203 million of mortgages--a capital leveraging of 40 to 1. It is estimated that FHA may lose at least $540 million on the mortgages underwritten by this defaulting coinsurer.

As the graph on Attachment II shows, the coinsurance programs were heavily concentrated among two large coinsurers who accounted for 55 percent of the risk. The five largest coinsurers accounted for 73 percent of the risk. This is particularly alarming considering the excessive exposure the largest coinsurers have in relation to their capital investment.

We believe that: (1) capital requirements should be established at such a level that coinsuring lenders will be induced to make sound loans; (2) criteria should be established that will deter the concentration of loans (and thus risk) among too few lenders; and (3) that delegated responsibilities should be continually and thoroughly monitored. The importance of these controls becomes apparent when bearing in mind that if coinsurers mismanage their 20 percent risk, that means they have mismanaged HUD's 80 percent risk as well. In

fact, HUD has had to pay off 100 percent of many of these coinsured loans. There are many similarities between this situation and the government's deposit insurance exposure in the savings and loan crisis.

We understand that based on what has been happening with the coinsurer program, HUD is conducting a review of participating coinsurers. We plan to review the results of HUD's efforts.

COMPLIANCE WITH LAWS AND REGULATIONS

The audit also disclosed a condition believed to be a material instance of noncompliance with laws and regulations. This was noncompliance with the Debt Collection Act of 1982 by failing to establish a receivable and to collect for amounts owed from mortgagees caused by a shortfall between the payoff of their defaulted mortgage and the amount realized from the sale of their foreclosed property.

IMPACT OF PROPOSED CHANGES TO THE MUTUAL MORTGAGE INSURANCE FUND

I would now like to direct my comments for a few moments from the audit of FHA's financial statements to the ongoing work we are performing to prepare a forecast analysis of FHA's Mutual Mortgage Insurance Fund (MMI Fund). This work is being done at the request of

Congressman Gerald Kleczka and this subcommittee expressed interest in our analysis when we testified in August. Specifically, we are analyzing policy options that include:

-- increasing the FHA mortgage insurance limit to 95 percent of a geographic region's median single-family home price;

-- reducing the required down payment on loans guaranteed by FHA; and

-- raising the interest rate caps on FHA-insured adjustable rate mortgages.

Since testifying on FHA before this subcommittee in August, we have obtained preliminary results in both our analysis of loan characteristics and estimation of claim and loss rates. The initial results tend to be consistent with our expectations based on prior studies and economic theory. For example:

-- Claim rates tend to peak in the second and third year after loan origination and then decline in subsequent years.

-- Claim rates increase for loans with higher loan-to-value ratios.

-- Current FHA higher valued mortgages (within current FHA loan

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limits) tend to have lower claim rates.

-- Claim rates decline as a homeowner's equity increases through pay back of the mortgage or through home price appreciation.

While we have obtained preliminary results in both our analysis of loan characteristics and estimation of claim and loss rates, we also have identified unforeseen problems and inconsistencies in the FHA database of insurance-in-force loans, primarily related to identifying claim dates in years prior to 1984. We believe that the source of the missing dates is associated with transferring data to a new computer system for the MMI Fund, installed at the end of fiscal year 1982. We believe that we can correct the problems we have identified and complete our work by early November. This analysis will establish a better understanding of loan performance and the likely impacts of various policy options on the solvency of the MMI Fund.

Even without the benefit of our forecast analysis, a number of relationships can be established regarding the probable impacts that the proposed changes would have on the MMI Fund. These relationships are based on what is generally known about the Fund's performance and historical claim and loss rates. For example, available data suggests that two of the proposals--lowering down payment requirements and raising interest rate caps on adjustable rate

mortgages--would be likely to increase FHA's claims and losses. The probable impact of raising the loan ceiling to 95 percent of the median home sales price, however, is not so clear.

We believe that raising the ceiling would be the most significant factor in increasing FHA's business. Data collected on 80 metropolitan areas by the National Association of Realtors shows that 14, or about 17 percent, have median home sale prices well above the current FHA loan limit. Overall, we believe a 20 percent increase in FHA business is possible if the 95 percent of median price proposal is adopted.

Based on our past work, we also believe that raising the loan ceiling could result in overall lower claim rates and, consequently, could help to boost FHA net revenues. However, the following two factors, which we are currently analyzing, could work against this scenario:

-- Analysis of FHA's database indicates that higher value loans within present FHA limits have lower claim rates, partly because these loans have had higher down payments associated with them. However, it can be anticipated that, as the ceiling amount of the loan is raised in high cost areas, many new borrowers will either not desire or not be able to make correspondingly higher down payments. Therefore, to the extent this happens, the potential risk associated with these

loans will increase.

-- When higher value loans default, losses might be higher than they are on lower value loans. Private mortgage insurers contend that loss rates rise with loan size. For example, in a weakened market, a $150,000 house might decline to $120,000, or 20 percent, while a $100,000 house might decline only to $90,000, or 10 percent.

As I mentioned earlier, we plan to complete our forecast analysis in early November by projecting, under various economic scenarios (current trend, optimistic, and pessimistic,) the status of the MMI Fund based on new loans over the next 10 years, assuming that the proposed changes are enacted. To provide a baseline for our analysis, we will also forecast the status of the Fund over the next 10 years, assuming that no changes are made to the program.

CURRENT FHA INITIATIVES

The new management at HUD under Secretary Kemp has started to address various deficiencies to strengthen FHA's financial position. In his August 1, 1989 letter to you, Mr. Chairman, Secretary Kemp outlined various initiatives he would take, including:

-- Stepping up monitoring and enforcement activities,

-- Redirecting FHA's accounting and computer systems,

-- Performing an independent actuarial analysis of the MMI and GI Funds,

-- Publishing annual audited financial statements,

-- Complying with recommendations resulting from the financial audit,

-- Reviewing the steps necessary to ensure full compliance with the Federal Managers' Financial Integrity Act, and

-- Reviewing lender requirements to ensure that only responsible and soundly capitalized firms participate in FHA programs.

I have met with Secretary Kemp and his management team and discussed our concerns with HUD's financial management problems. The Secretary has stated his strong desire to improve HUD's financial management problems and we look forward to working with him.

CONCLUSIONS

As we have stated, the 1988 financial audit reveals that FHA has sustained substantial losses, particularly in the MMI and GI Funds. These losses are directly attributable to rising defaults in

economically stressed regions, losses from sales of foreclosed properties, and the failure of several large coinsurers. The extent of losses attributable to program fraud and abuse is not yet known.

There are, however, a number of serious problems in the financial management of FHA which contribute to its losses. These problems are exemplified in the serious lack of monitoring of responsibilities delegated to the private sector, the poor quality of financial information available to management, the weak financial management systems and internal control procedures, the shoddy performance of essential accounting functions, and management's inattention to weaknesses identified by GAO, the Inspector General, and its own FMFIA reports. We are also concerned about the level of capital required for the GI multifamily coinsurance program.

These financial management problems open FHA to mismanagement and an unnecessary risk that fraud and abuse will occur and not be detected. They also impair management's ability to assess the level of risk arising from normal insurance operations. Accurate and timely financial information for each program and location are essential to effectively manage FHA's insurance programs.

FHA's accounting and financial management problems have been long-standing and well documented. Correction of these problems will require multiyear solutions and a long-term commitment by top management. I strongly believe that top management needs to develop

an action plan with milestones addressing the improvements needed in FHA/HUD's accounting and financial management systems. The plan should also provide for better accountability and discipline in financial reporting and the continued performance of annual financial audits.

I believe that an important part of the solution to HUD/FHA's problems is to establish a Chief Financial Officer within HUD and a corresponding Comptroller within FHA. A Chief Financial Officer would be responsible for setting accounting and financial reporting policies, directing the development and operation of financial management systems, and ensuring the maintenance of a sound internal control structure. The FHA Comptroller would share the same responsibilities as the HUD Chief Financial Officer, but within FHA. Both of these individuals should also be held responsible for implementation and monitoring of the corrective action plan.

Mr. Chairman, I would like to point out that it is because FHA has begun to prepare financial statements and, most importantly, that these statements have been independently audited, that we are now able to see the magnitude of FHA's problems. Regular audits of these statements are necessary to give the Congress an objective assessment of how management has been performing. FHA's fiscal year 1988 results, as reported by HUD, showed a loss of only $858 million, which is far less serious than the $4.2 billion loss as determined by the independent audit.

In order for the Congress to deal appropriately with this program, or any other program, it must have financial information it can rely on. To aid in its oversight role, I believe Congress should monitor HUD's progress through an annual oversight hearing on the annual report from the Secretary which should include financial statements, the independent auditor's opinion, reports on internal controls and compliance, and management's report required by the Federal Managers' Financial Integrity Act.

This concludes my statement, Mr. Chairman. We will be pleased to respond to any questions you or members of the Committee may have.

ATTACHMENT I

ATTACHMENT I

SUMMARY OF FY 88 RESULTS OF OPERATIONS

	Self-Sustaining		Subsidized		
	MMI Fund	CMHI Fund	GI Fund	SRI Fund	FHA Totall
	in billions				
Insurance-in-force	$229	$0.5	$62	$12	$303
REVENUE:					
Premiums earned	1.5	*	0.3	*	1.9
Interest and other	0.6	*	0.1	*	0.8
Total revenue	2.1	*	0.4	0.1	2.7
EXPENSES:					
Increase in loss reserves	(1.2)	(0)	(2.1)	(*)	(3.4)
Losses on property sales	(1.7)	(0)	(0.3)	(0.1)	(2.1)
Interest and other	(0.6)	(*)	(0.6)	(0.2)	(1.4)
Total expenses	(3.5)	(*)	(3.0)	(0.4)	(6.9)
RESULTS OF OPERATIONS	(1.4)	*	(2.6)	(0.3)	(4.2)
GOVERNMENT EQUITY, 1987	3.4	*	(0.8)	(1.4)	1.2
Appropriations	0	0	0.3	0.1	0.3
Distributions	(0.2)	(*)	0	0	(0.2)
GOVERNMENT EQUITY, 1988	1.8	*	(3.1)	(1.6)	(2.9)

*Less than $100 million

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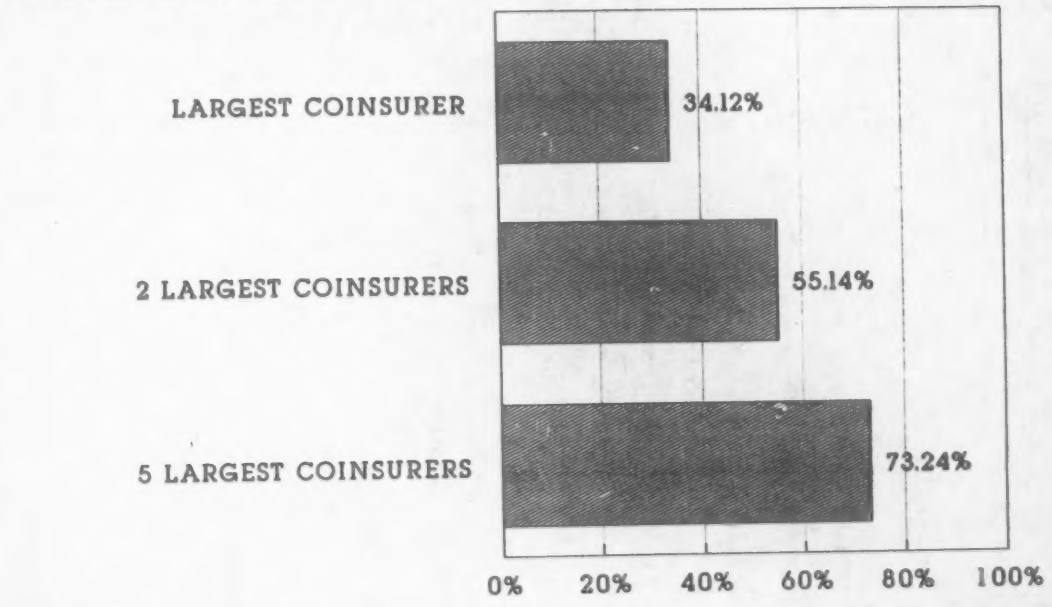
[1]Totals do not add due to rounding.

CONCENTRATION OF RISK AMONG THE LARGEST COINSURERS

PERCENT INSURED WITH:



ACTIONS NEEDED TO ADDRESS FHA PROBLEMS

- Develop a management action plan with milestones that corrects reported weaknesses and achieves monitoring of FHA operations
- Evaluate coinsurance capitalization requirements
- Establish Chief Financial Officer at HUD and a Comptroller at FHA to
  - monitor action plan
  - set accounting and financial reporting policies
  - oversee financial management systems
  - develop adequate internal controls
- Issue annual audited financial statements
- Improve Congressional oversight

Price Waterhouse

September 15, 1989

To the Secretary
Department of Housing and Urban Development:

We were engaged to audit the accompanying consolidated statements of financial position of the Federal Housing Administration (FHA), a fund of the Department of Housing and Urban Development (HUD), as of September 30, 1988 and 1987, and the related consolidated statements of operations and government equity (deficiency), and of cash flows for the fiscal year ended September 30, 1988. These financial statements are the responsibility of FHA's management.

Allegations have been made about improper diversions of property sales proceeds by certain private closing agents contracted by HUD to sell HUD-owned property. This property is reported in the FHA financial statements. The alleged diversions resulted, in part, from internal control weaknesses involving HUD's inability to properly monitor the collection and prompt deposit of property sales proceeds, or to maintain an accurate inventory of foreclosed properties. The Inspector General has estimated that such improper diversions, may lead to substantial losses, but to date, the amount of the losses that will ultimately be incurred by HUD has not been determined, nor is HUD able to ascertain how much, if any, of these losses are already reflected in the 1988 financial statements. Further, ongoing investigations into this matter have not yet been completed. There are a number of other investigations currently being conducted about other alleged improprieties involving HUD's administration of FHA. These investigations could reveal violations of laws and regulations, but to date, a final determination about such violations has not yet been made. We have been unable to apply other auditing procedures to satisfy ourselves regarding the alleged improper diversions of property sale proceeds or the extent to which the inventory of foreclosed property reflected in the accompanying financial statements may be misstated, nor were we able to determine the possible impact on the financial statements of other investigations currently being conducted. These matters could have a significant impact on FHA's financial position, results of operations and cash flows.

As discussed in Note 8, FHA's General Insurance (GI) Fund has incurred substantial losses primarily relating to its multifamily coinsurance programs, and to a lesser degree, to its insurance of hospital mortgages. In September 1988, the Government National Mortgage Association (GNMA), a government corporation operated by HUD which guarantees securities backed by FHA-coinsured multifamily mortgages, declared a major FHA lender/coinsurer in

default of its GNMA obligations. Subsequent to September 1988, GNMA similarly declared two more large FHA lender/coinsurers in default. Because FHA insures the mortgages underlying the GNMA securities, substantially all losses relating to these defaulted lender/coinsurers will be borne by FHA. A provision of $960 million has been recorded in the fiscal year 1988 consolidated statement of operations for estimated losses resulting from these and other probable defaults in the multifamily coinsurance programs. However, because of weaknesses in the multifamily coinsurance programs involving required levels of capital and coinsurer monitoring, it is possible that more lender/coinsurers will default and cause substantial additional losses in the GI Fund. Also, a provision of $275 million has been recorded in the consolidated statement of operations for probable defaults of FHA-insured hospital mortgages. Even a limited number of defaults of these large mortgages could place a serious financial burden on the GI Fund, and could render the hospital insurance premiums insufficient to cover related losses. HUD's actuary has determined that, in the aggregate, the GI Fund's premiums are insufficient to cover its losses, and the Fund is dependent on the U.S. Treasury and on budget appropriations to sustain its operations. However, given the probability that additional losses will take place, FHA cannot presently estimate the degree of its premium insufficiency or the level of support it will ultimately require from Treasury. The accompanying financial statements do not include any adjustments for these uncertainties which, if known, could be material in relation to FHA's financial position and results of operations.

As discussed in Note 1, FHA comprises four major activities, the MMI, CMHI, GI and SRI Funds. The MMI and CMHI Funds are operated as mutual insurance funds and are required to be "actuarially sound". The largest FHA activity is the MMI Fund, a fund which insures single family home mortgages and which comprises $228.5 billion of FHA's $303.4 billion of insurance in force. Although the MMI Fund incurred, on an accrual basis, losses of $1.4 billion for fiscal year 1988, it still reports government equity of $1.8 billion. Despite its current losses, HUD's actuary has estimated that the MMI Fund's future revenue will exceed its future expenses. However, there are studies currently underway to determine whether there are structural weaknesses in the MMI Fund that must be addressed. For fiscal year 1988, the CMHI Fund, FHA's smallest activity, paid no claims, reported an excess of revenues over expenses, and showed positive government equity. The GI and SRI Funds are not mutual insurance funds, have no requirement that they be actuarially sound, and contain programs that have had continuing losses. Neither the GI Fund's nor the SRI Fund's premiums are sufficient to cover their losses leaving them dependant on the U.S. Treasury and on budget appropriations to sustain their operations.

In our report dated August 12, 1988 expect for Note 4, for which the date was November 15, 1988, we expressed an opinion that the consolidated statement of financial position at September 30, 1987 presented fairly the financial position of the Federal Housing Administration in conformity with generally accepted accounting principles. However, the allegations about the diversion of property sales proceeds, possible misstatements of the inventory of foreclosed properties, and the unknown outcome of other investigations referred to in the second paragraph of this report may have affected FHA's financial position at September 30, 1987. Accordingly, with respect to the September 30, 1987 consolidated statement of financial position, our report as presented herein, is different from that previously issued.

HUD has not yet determined (1) the extent of the diversion of property sales proceeds, (2) the extent to which foreclosed property reflected in the accompanying financial statements may be misstated, or (3) the effect that the outcome of other investigations might have on FHA's financial statements. Nor were we able to satisfy ourselves about the effect of these matters, which could have a significant impact on the accompanying financial statements. Therefore the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying financial statements.

We were engaged for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of FHA's major activities. For the reasons described in the preceding paragraph, we are unable to, and do not, express an opinion on whether the consolidating information is fairly stated, in all material respects, in relation to the consolidated financial statements taken as a whole.

Price Waterhouse

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF OPERATIONS AND GOVERNMENT EQUITY (DEFICIENCY)
FOR THE YEAR ENDED SEPTEMBER 30, 1988
(Dollars in Thousands)

REVENUES:	
Premiums:	
Monthly Premiums	$ 431,196
Earned Portion of One-time and Annual Premiums	1,444,393
Net Premiums Earned	1,875,589
Interest Income	721,731
Other Revenues	67,194
Total Revenues	2,664,514
EXPENSES:	
Net Increase in Loss Reserves	3,363,608
Realized Losses on Sales of Properties	2,073,674
Provision for Losses on Properties Owned	271,806
Provision for Losses on Mortgage Notes Held	290,458
Salary and Administrative Expenses	455,213
Interest Expense	338,628
Other Expense	101,122
Total Expenses	6,894,509
Deficiency (Losses) of Revenues over Expenses	(4,229,995)
Government Equity, Beginning of Year	1,188,676
Appropriations	350,093
Distributive Shares Paid	(162,797)
Government (Deficiency), End of Year	$ (2,854,023)

The notes to the financial statements are an integral part of this statement.

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF FINANCIAL POSITION
SEPTEMBER 30, 1988 AND 1987
(Dollars in Thousands)

	September 30, 1988	1987
ASSETS:		
Fund Balance with the U.S. Treasury	$ 113,108	$ 175,331
Investments in U.S. Government Securities Principally Non-marketable (Note 3)	6,208,004	6,651,427
Foreclosed Property Held for Sale, Net (Note 4)	1,696,364	1,432,116
Mortgage Notes Receivable, Net (Note 6)	2,913,127	2,808,597
Appropriations Receivable (Note 7)	587,813	400,586
Other Assets and Receivables	268,339	437,629
Total Assets	$ 11,786,755	$ 11,905,686
LIABILITIES AND GOVERNMENT EQUITY:		
Claims Payable	628,692	525,759
Loss Reserves (Note 8)	5,411,000	2,047,392
Unearned Premiums (Note 9)	3,994,668	3,983,749
Debentures Issued to Claimants (Note 10)	119,545	175,743
Accounts Payable, Accrued Expenses and Other Liabilities	351,472	302,775
Distributive Shares and Premium Refunds Payable	142,133	150,158
Borrowings from the U.S. Treasury (Note 11)	3,993,268	3,531,434
Total Liabilities	14,640,778	10,717,010
Government Equity (Deficiency) (Note 13):		
Mutual Funds Equity	1,806,811	3,375,571
Subsidized Funds Cumulative Losses	(9,941,681)	(7,117,649)
Appropriated Capital	5,280,847	4,930,754
Total Government Equity (Deficiency)	(2,854,023)	1,188,676
Commitments and Contingencies (Note 12)		
Total Liabilities and Government Equity	$ 11,786,755	$ 11,905,686

The notes to the financial statements are an integral part of this statement.

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATED STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED SEPTEMBER 30, 1988
(Dollars in Thousands)

Net Cash Flows from Operating Activities:	
Deficiency of Revenues over Expenses (Losses)	$ (4,229,995)
Non Cash Expenses, Revenues, Losses and Gains Included in Operations:	
Realized Losses on Sales of Properties	2,073,674
Net Increase in Loss Reserves	3,363,608
Premiums Earned	(1,444,393)
Increase in Loss Allowances on Properties and Mortgages	562,264
Decrease in Other Assets	169,292
Increase in Claims Payable and Other Liabilities	143,605
Amortization of Discounts on Investments and Notes	3,941
Assets Acquired in Claims Settlement	(6,506,494)
Collections of Principal on Notes Acquired in Claims Settlement	217,800
Proceeds from Disposition of Assets Acquired in Claims Settlement	3,084,869
Premiums Collected	1,588,811
Premiums Refunded	(133,499)
Net Cash Used by Operations	(1,106,517)
Cash Flows from Investing Activities:	
Purchase of Investment Securities	(3,180,905)
Proceeds from Sales of Investment Securities	3,622,328
Issuance of Purchase Money Mortgages	(3,428)
Collections of Principal on Purchase Money Mortgages	104,643
Proceeds from Disposal of Purchase Money Mortgages	95,944
Net Cash Provided by Investing Activities	638,582
Cash Flows from Financing Activities:	
Appropriations Received	162,866
Borrowings from the U.S. Treasury	680,000
Issuance of Debentures to Claimants	48,877
Payment of Borrowings to the U.S. Treasury	(218,166)
Payment of Debentures	(105,068)
Distributive Shares Paid	(162,797)
Net Cash Provided by Financing Activities	405,712
Net Decrease in Cash	$ (62,223)

The notes to the financial statements are an integral part of this statement.

FEDERAL HOUSING ADMINISTRATION

(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 1988

Note 1. Description of Entity and Significant Accounting Policies:

A. Entity and Mission:

The Federal Housing Administration (FHA) was established in 1934 and became a wholly owned government corporation in 1948 subject to the Government Corporation Control Act, as amended. FHA administers some 40 active mortgage insurance programs, thereby making mortgage financing more readily accessible to the home buying public. Its programs are designed primarily to serve first-time home buyers and to provide affordable multifamily housing.

The FHA programs are organized into four major activities. (1) the Mutual Mortgage Insurance Fund (MMI), FHA's largest activity, provides basic (principally 30 year) single family mortgage insurance. It is a mutual insurance fund whereby mortgagors, upon non-claim termination of their mortgages, share surplus premiums paid into the fund that are not required for operating expenses and losses; (2) the Cooperative Management Housing Insurance Fund (CMHI), also a mutual fund, provides mortgage insurance for management-type cooperatives authorized by Section 213 of the National Housing Act, as amended; (3) the General Insurance Fund (GI), provides for a large number of specialized mortgage insurance programs, including insurance of loans for property improvements as well as for cooperatives, condominiums, housing for the elderly, land development, group practice medical facilities and nonprofit hospitals; and (4) the Special Risk Insurance Fund (SRI), provides mortgage insurance on behalf of mortgagors eligible for interest reduction payments who otherwise would not be eligible for mortgage insurance. SRI also provides insurance for high-risk mortgagors who normally would not be eligible for mortgage insurance.

The National Housing Act, as amended, authorizes appropriations to restore certain losses sustained from mortgage insurance operations of the GI and SRI Funds, which contain subsidized activities.

Note 1. Description of Entity and Significant Accounting Policies (continued):

A. Entity and Mission (continued):

While FHA was established as a separate federal entity, it was subsequently merged into the Department of Housing and Urban Development (HUD) when that department was created. FHA no longer has separate staff or facilities. Instead, FHA operations are conducted, along with other Housing activities, by HUD organizations. FHA is headed by HUD's Assistant Secretary for Housing - Federal Housing Commissioner who reports to the Secretary of HUD. FHA activities are included in the Housing section of the HUD budget.

B. Basis of Accounting:

The Consolidated Statement of Financial Position, Statement of Operations and Government Equity, and Statement of Cash Flows, have been prepared in accordance with generally accepted accounting principles. All interfund balances and transactions have been eliminated.

C. Fund Balance with the U.S. Treasury:

Substantially all of FHA's receipts and disbursements are processed by the U.S. Treasury which, in effect, maintains FHA's bank accounts. For purposes of the Consolidated Statement of Cash Flows, FHA's funds in the U.S. Treasury are considered cash.

D. Investments in U.S. Government Securities:

The National Housing Act, as amended, limits FHA's investments to non-marketable Treasury interest bearing obligations (i.e., investments not sold in public markets). The market value and interest rates established for such investments are the same as those for similar Treasury issues which are publicly marketed.

Unlike private sector entities, FHA's investment decisions are limited by Treasury policy which (1) only allows FHA to invest in notes and bonds with maturities of six months or more (although FHA may invest in Treasury bills with maturities of less than six months), and (2) prohibits FHA from engaging in practices that result in "windfall" gains and profits such as security daytrading and full scale restructuring of portfolios in order to take advantage of interest rate fluctuations.

Investments in U.S. Government securities are reported at cost, net of unamortized premiums or discounts. Premiums or discounts are amortized into interest income over the term of the investment. FHA's intent is to hold investments to maturity, unless they are needed to finance mortgage insurance claims or otherwise sustain the operations of the fund. No provision is made for unrealized gains or losses on these securities because, in the majority of cases, they are held to maturity.

Note 1. Description of Entity and Significant Accounting Policies (continued):

E. Mortgage Notes Receivable:

Mortgage notes receivable consist of mortgage notes received in claims settlement and purchase money mortgages issued to buyers of FHA's foreclosed properties. Under certain conditions prescribed by regulation, FHA will assume insured mortgages which are in default rather than acquire the properties through foreclosure. Generally, mortgages will be assumed where the mortgagor has defaulted due to certain "temporary hardship" conditions beyond the control of the mortgagor, and where, in management's judgment, it is likely that the mortgage can be brought current in the future. However, the majority of FHA claims do not result in the assumption of notes. Purchase money mortgages were previously issued, in certain circumstances, to buyers of FHA owned property acquired in the settlement of insurance claims. Under current policies, however, FHA rarely issues purchase money mortgages to sell foreclosed property.

Both mortgage notes received in claims settlement and purchase money mortgages are recorded at the lower of cost or fair value. Fair value is based on prevailing market interest rates at dates of mortgage issue or assumption, as applicable. When fair value is less than cost, discounts are recorded and amortized to interest income over the initial or remaining terms of the mortgages. Interest income is recognized as income when earned. When full collection of principal is considered doubtful, an allowance for losses is recorded, the accrual of interest income is suspended and receipts (both interest and principal) are recorded as collections of principal. Purchase money mortgages and notes received in claims settlement are reported net of the allowance for loss and any unamortized discount.

F. Foreclosed Property Held for Sale:

Foreclosed property held for sale is reported net of an allowance for loss, which is established to reduce the property carrying value to the estimated net realizable value -- the amount FHA expects to receive in cash upon sale of the property.

G. Loss Reserves:

Loss reserves, which comprise undiscounted claims loss reserves and loss adjustment expense reserves, are provided for estimated losses incurred by FHA to pay claims on insured mortgages when defaults have taken place, but where claims have not yet been filed.

Note 1. Description of Entity and Significant Accounting Policies (continued):

H. Premiums and Unearned Revenue:

FHA's largest activity, the insurance of single family mortgages by MMI, charges a one-time premium upon insurance initiation. Such premiums are recorded as unearned revenue upon collection and then recognized as revenue over the historical loss period as determined by HUD's actuary. Mortgagors may finance payment of the one-time premium by adding it to the mortgage principal. The one-time premium went into effect in fiscal year 1984. FHA's other activities, including most of those conducted through the GI and SRI Funds, charge periodic premiums over the mortgage insurance term. Premiums on annual installment policies are earned on a straight-line basis throughout the year. All other policies earn premiums on a monthly basis.

I. Appropriations and Funds Received from Other HUD Programs:

Appropriations to cover losses for the GI and SRI Funds are recorded as restoration of capital at the time property and notes are sold rather than at the time losses are initially incurred. These appropriations, which are typically not received until two years after the receivable is established, do not cover interest incurred on Treasury borrowings which are necessary to fund losses during the intervening period between the initial request and ultimate receipt of funds.

Funds received from other HUD programs, such as for interest subsidies and rent supplements, are recorded as revenue when as services are rendered.

J. Distributive Shares:

As mutual funds, MMI and CMHI distribute, from time to time, excess revenues to policyholders at the discretion of the Secretary of HUD. Such distributions are determined based on MMI and CMHI's financial positions and their projected revenues and costs.

Note 2. Intragovernmental Financial Activities:

FHA is an integral part of the operations of HUD, and is thus subject to financial decisions and management controls of the Secretary of HUD. Similarly, FHA is also subject to financial decisions and management controls of the Office of Management and Budget (OMB). As a result of its relationship with HUD and OMB, FHA's operations may not be conducted nor its financial position reported as they would if FHA were a separate and unrelated entity.

Note 2. Intragovernmental Financial Activities (continued):

Interest Subsidies, Rental Supplements and Other Assistance:

HUD provides interest subsidies, rental supplements and other assistance to certain eligible mortgagors and/or occupants of single and multifamily properties which FHA insures, or holds the mortgage or owns the underlying property. In those cases where FHA either holds the mortgage or owns the property, it receives any benefit payments from HUD on behalf of those individuals who are repaying the loan or occupying the property.

During fiscal year 1988, FHA received directly the following interest subsidy, rental supplement and other assistance payments from HUD (dollars in thousands):

Single Family Notes – Interest Subsidy	$ 2,265
Multifamily Notes – Interest Subsidy	42,581
Rental Supplements for Low Income Individuals Occupying Multifamily Properties	794
Rental Supplements for Low and Very Low Income Families Living in Multifamily Properties	7,117
Payments for Acquired Homes Utilized for Urban Homesteading	11,344
Total	$ 64,101

To the extent FHA-insured mortgagors receive interest subsidy and/or rental supplement payments, FHA benefits indirectly since these assistance payments will reduce the risk of the mortgagors' failing to repay the FHA-insured loans. The amount of HUD assistance to FHA-insured mortgagors or to occupants of multifamily property financed through FHA-insured mortgages is not presently determinable. Amounts receivable from HUD as of September 30, 1987 and 1988 for the above assistance programs are not material.

Administrative Expenses Reimbursed to HUD:

HUD is reimbursed by FHA for personnel, property and equipment, and administrative services costs since all FHA operations are performed by HUD personnel. These annual reimbursements are budgeted amounts approved by the Congress each fiscal year. They are based on the estimated staff levels to carry out FHA activities, not the time actually worked by HUD personnel on those activities.

Allocated personnel costs for which FHA reimburses HUD include matching contributions to the Civil Service Retirement System (CSRS) and the Federal Employees Retirement Systems (FERS). FERS went into effect for all HUD employees on January 1, 1987 pursuant to Public Law 99-335. FHA does not report its portion of the CSRS or FERS actuarial present value of accumulated benefits or of the unfunded pension liability, since these amounts are reported in total by the Office of Personnel Management.

Note 2. Intragovernmental Financial Activities (continued):

Insurance Provided to Other Federal Entities:

FHA provides mortgage insurance to individuals employed by other Federal entities. These Federal entities bear the premium cost of insurance provided by FHA. Individuals covered include servicemen in the Armed Forces (Department of Defense), servicemen in the United States Coast Guard (Department of Transportation), and servicemen in the National Oceanic and Atmospheric Administration (Department of Commerce). Insurance in force outstanding for individuals employed by these Federal entities was approximately $754 million as of September 30, 1988 and approximately $849 million as of September 30, 1987.

Note 3. Investments in U.S. Government Securities:

Investments in U.S. Government securities as of September 30, 1988 were as follows (dollars in thousands):

Maturity	Description	Amortized Cost	Market Value
Less than One Year	Treasury Bills and Notes	$ 820,037	$ 812,892
One to Five Years	Treasury Notes and Bonds	1,925,663	1,978,237
Five to Ten Years	Treasury Notes and Bonds	1,756,882	1,701,694
Ten to Fifteen Years	Treasury Bonds	783,991	751,730
Over Fifteen Years	Treasury Bonds	921,431	893,041
Total Investments		$ 6,208,004	$ 6,137,594

As of September 30, 1987, investments in U.S. Government securities were as follows (dollars in thousands):

Maturity	Description	Amortized Cost	Market Value
Less than One Year	Treasury Bills and Notes, and GNMA Certificates	$ 522,361	$ 522,127
One to Five Years	Treasury Notes and Bonds	1,948,751	1,949,614
Five to Ten Years	Treasury Notes and Bonds	2,338,157	2,221,421
Ten to Fifteen Years	Treasury Notes and Bonds	898,905	819,985
Over Fifteen Years	Treasury Bonds	943,253	863,700
Total Investments		$ 6,651,427	$ 6,376,847

Note 3. Investments in U.S. Government Securities (continued):

During 1988 FHA's MMI Fund redeemed, before maturity, investments with a carrying value of $642.6 million and recorded a gain of $12.2 million. It is FHA's normal policy to hold investments to maturity unless otherwise needed to sustain operations. If investments owned as of September 30, 1988 had been held as of September 15, 1989, their market value would have been approximately $6.3 billion.

Note 4. Foreclosed Property Held for Sale:

Foreclosed property held for sale is obtained in claims settlement and was composed of the following classes of property at September 30, 1988 and 1987 (dollars in thousands):

Description	1988	1987
Single Family Homes	$ 2,870,401	$ 2,337,033
Multifamily Properties	195,328	192,642
Total Property	3,065,729	2,529,675
Allowance for Losses	(1,369,365)	(1,097,559)
Property, Net	$ 1,696,364	$ 1,432,116

The allowance for losses is recorded to reduce the property carrying value to the amount FHA expects to receive in cash when properties are sold. The allowance is necessary because historically FHA has not recovered the full value of its foreclosed property.

Note 5. Proposed Loan Sales:

During fiscal year 1988 and 1987, HUD attempted to sell certain multifamily loans that were held by FHA as of September 30, 1988 and 1987 under the Federal government's loan asset sale program. That program requires that loans be sold without recourse provisions. The subject loans were originally offered for sale, without recourse, in May 1987. However, that sale was challenged in court (Walker, et al. v. Pierce, 665 F. Supp. 831 (N.D. Cal. 1987)) on the grounds that sale of the mortgages on a non-insured basis would terminate the regulatory agreements between HUD and the project mortgagors and that termination of the regulatory agreements would deprive the tenants of a number of benefits and protection available to insured projects.

Note 5. Proposed Loan Sales (continued):

HUD had been attempting to sell 140 of these loans with a carrying value of approximately $255 million, but was unable to structure their sale without recourse provisions. Accordingly, efforts to sell the subject loans have now been terminated.

In a separate transaction during 1988, HUD sold, without recourse, $100.6 million of multifamily notes for $69.8 million. Also, under an option which offered discounts to single family mortgagors who prepaid their loans, FHA received $15.8 million on $17.8 million of single family mortgage notes.

Note 6. Purchase Money Mortgages and Mortgage Notes Assigned to FHA:

Most of the mortgage notes held were assigned to FHA when mortgagors defaulted (i.e. mortgage notes assigned, MNAs). FHA does not normally provide financing (through purchase money mortgages, PMMs) to sell foreclosed property. FHA assumes notes when defaults result from temporary hardship conditions. Many of the notes FHA assumes are at interest rates below prevailing market rates at the time of assumption, hence, discounts are recorded. As discussed below, many others are either in default or are no longer generating interest income, and an allowance for losses is recorded on these notes.

PMMs and MNAs comprise the following at September 30, 1988 and 1987 (dollars in thousands):

Description	PMM	MNA	1988 Total	1987 Total
Single Family	$ 123,816	$ 1,411,004	$ 1,534,820	$ 1,454,746
Multifamily	145,494	2,648,549	2,794,043	2,531,233
Mobile Homes and Improvements (Title I)	0	290,745	290,745	267,689
	269,310	4,350,298	4,619,608	4,253,668
Unearned Discounts	(48,199)	(375,915)	(424,114)	(344,000)
Allowances for Losses	(31,378)	(1,250,989)	(1,282,367)	(1,101,071)
Mortgages, Net	$ 189,733	$ 2,723,394	$ 2,913,127	$ 2,808,597

Interest income for the year ended September 30, 1988 was $12.2 million on PMMs and $150.1 million on MNAs.

Note 6. Purchase Money Mortgages and Mortgage Notes Assigned to FHA (continued):

Mortgages on which the accrual of interest has been discontinued or reduced, are estimated to be approximately $96 million for PMMs and $2.62 billion for MNAs at September 30, 1988, and $189 million for PMMs and $2.44 billion for MNAs at September 30, 1987. If interest on those mortgages and notes had been accrued for the year ended September 30, 1988, that interest income would have approximated $10.7 million on PMMs and $198.2 million on MNAs.

Mortgages which are considered current but which are under forbearance agreements comprise approximately $10.4 million of PMMs and $754 million of MNAs.

Changes in the allowance for losses and unearned discounts on PMMs and MNAs for the year ended September 30, 1988, were (dollars in thousands):

	PMM	MNA	Total
Balance, Beginning of Year	$ 141,225	$ 1,303,846	$ 1,445,071
Change in Allowance Charged to Operations	(61,648)	352,106	290,458
Notes Written Off	0	(29,048)	(29,048)
Balance, End of Year	$ 79,577	$ 1,655,952	$ 1,706,481

Note 7. Appropriations Receivable:

Appropriations receivable at September 30, 1988 comprise the following (dollars in thousands):

	GI	SRI	1988 Total
Relating to:			
Losses on Property Sales in Fiscal Year 1987 to Be Received in Fiscal Year 1989	$ 161,133	$ 76,587	$ 237,720
Losses on Property Sales in Fiscal Year 1988 to Be Received in Fiscal Year 1990	257,128	92,965	350,093
Total	$ 418,261	$ 169,552	$ 587,813

The fiscal year 1989 appropriation (relating to certain 1987 losses) has been approved pursuant to P.L. 100-404. As of September 15, 1989 the fiscal year 1990 appropriation (relating to certain 1988 losses) had been reported on favorably by both the Senate and House Committees on Appropriations. Appropriations receivable were $400.6 million at September 30, 1987.

Note 8. Loss Reserves:

Loss reserves, which comprise undiscounted claims loss reserves and loss adjustment expense (LAE) reserves, were as follows as of September 30, 1987 and 1988 (dollars in thousands):

Fund	Claims Loss Reserve	LAE Reserve	1988 Total	1987 Total
MMI	$ 2,557,000	$ 107,000	$ 2,664,000	$ 1,417,489
CMHI	0	0	0	0
GI	2,537,000	73,000	2,610,000	557,217
SRI	125,000	12,000	137,000	72,686
Total	$ 5,219,000	$ 192,000	$ 5,411,000	$ 2,047,392

The claims loss reserve is provided for estimated losses incurred by FHA to pay claims on insured mortgages where defaults have taken place, but where claims have not yet been filed. The reserve is estimated based on historical claim and loss experience data, adjusted for judgments concerning current economic factors. The LAE reserve is provided for estimated administrative expenses of settling filed claims and reported defaults.

Loss reserves in the GI Fund were increased significantly during 1988 because of defaults in the Fund's multifamily coinsurance programs and, to a lesser degree, because of potential defaults of FHA insured hospital mortgages. Under the multifamily coinsurance programs, eligible lenders/coinsurers perform underwriting, servicing, management, and property disposition functions and assume responsibility for a portion of any insurance loss (up to a maximum of approximately 20 percent of the loan). Substantially all FHA coinsured multifamily mortgages are sold through the issuance of mortgage-backed securities that are fully guaranteed by the Government National Mortgage Association (GNMA), a government corporation operated by HUD.

In September 1988, GNMA declared a major FHA lender/coinsurer in default of its obligations for GNMA securities backed by multifamily coinsured mortgages. Subsequent to September 1988, GNMA similarly declared two more large FHA lender/coinsurers in default. FHA's losses on these coinsurer defaults will be substantial and are exacerbated by the fact that the coinsurer defaults will cause FHA to assume full insurance responsibility and bear 100 percent of any insurance losses. A provision of approximately $960 million has been recorded for these and other reported defaults in the coinsurance programs. However, because of structural weaknesses in the basic multifamily coinsurance programs, it is possible that still more coinsurer defaults may occur and cause substantial additional losses.

Note 8. Loss Reserves (continued):

A provision of $275 million has been recorded for probable defaults of FHA-insured hospital mortgages, a program which is part of the GI Fund. Changes in external conditions which affect occupancy rates are partly responsible for delinquencies and defaults of these mortgages, and could cause additional defaults in the future. Even a limited number of defaults of these large mortgages could place a serious financial burden on the GI Fund, and could quickly render its premiums insufficient to cover insurance losses.

In any case, aggregate premiums generated by the GI Fund's various programs will not be sufficient to cover the Fund's losses, nor to sustain its operations. Furthermore, given uncertainties about the level of additional losses that may occur, particularly in the coinsurance and hospital mortgage insurance programs, it is not currently possible to estimate how much the premium deficiency will be.

The severity of the GI Fund's losses and the insufficiency of its premiums leaves the Fund dependent on the U.S. Treasury to sustain its operations. The GI Fund will not, in the foreseeable future, be able to repay Treasury without the infusion of appropriated funds.

Activity under all of the SRI Fund's major categories has decreased substantially in recent years. The majority of the SRI Fund's losses have already occurred and are reflected in the Fund's equity balance. In addition, HUD's actuary now believes that the SRI Fund's future income will exceed its future expenses.

Note 9. Unearned Premiums:

The following shows the activity in unearned premiums during 1988 (dollars in thousands):

	MMI	CMHI	GI	SRI	Total
Balance, Beginning of Year	$ 3,837,536	$ 1,544	$ 124,388	$ 20,281	$ 3,983,749
Premiums Collected	1,345,513	2,267	208,420	32,611	1,588,811
Premiums Earned	(1,171,870)	(2,671)	(232,967)	(36,885)	(1,444,393)
Premium Refunds	(133,496)	0	(3)	0	(133,499)
Balance, End of Year	$ 3,877,683	$ 1,140	$ 99,838	$ 16,007	$ 3,994,668

Note 10. Debentures Issued to Claimants:

The National Housing Act authorizes FHA to, in certain cases, issue debentures, in lieu of cash to pay claims. FHA-issued debentures bear interest at rates established by Treasury. They may be redeemed by mortgagees prior to maturity to pay mortgage insurance premiums to FHA.

On January 1, 1988, the Federal Housing Commissioner called GI Fund debentures (MM series) outstanding as of September 30, 1987 with coupon rates of 8.25 percent or higher. Government and public debentures redeemed totalled $20 million and $72 million, respectively. The remaining debentures, substantially all of which mature after fiscal year 1992, bear interest at rates ranging from 2.5 to 12.75 percent. Interest paid during the year ended September 30, 1988 on debentures was $17.9 million.

Note 11. Borrowings from the U.S. Treasury:

The National Housing Act, as amended, allows FHA's GI and SRI Funds to borrow cash from the U.S. Treasury at Treasury's established lending rates for Federal departments and agencies. Borrowings from Treasury cannot exceed the total amount of claims paid by FHA. They typically have a 15 year term, but may be repaid prior to maturity at the discretion of FHA. However, such borrowings must be repaid in the sequence in which they were borrowed from Treasury.

Borrowings outstanding at September 30, 1988 are payable from the GI and SRI Funds. Given the losses experienced by these Funds in the past and those expected for the foreseeable future, management believes that repayment can only be accomplished through new borrowings, or through rescheduling maturity dates.

Outstanding borrowings from the U.S. Treasury at September 30, 1988 and 1987 were as follows (dollars in thousands):

	1988	1987
Borrowings from the U.S. Treasury; Interest Payable on June 30 and December 31; Interest Rates Ranging from 6.875% to 14.5%.		
Current Portion	$ 431,000	$ 218,166
Long-term Portion	3,562,268	3,313,268
Total	$ 3,993,268	$ 3,531,434

Projected principal payments for the next five fiscal years and thereafter are (dollars in thousands): $431,000 in 1989, $693,268 in 1990, $965,000 in 1991, $325,000 in 1992, $311,000 in 1993 and $1,268,000 thereafter. Interest paid during the year ended September 30, 1988 on borrowings was $300.3 million.

Note 12. Commitments and Contingencies:

Insurance in Force:

Total outstanding insurance in force was as follows at September 30, 1988 (dollars in thousands):

Fund	Single Family	Multifamily	Title I	1988 Total
MMI	$ 228,520,354	$ 0	$ 0	$ 228,520,354
CMHI	0	516,171	0	516,171
GI	16,989,908	37,949,395	7,000,000 *	61,939,303
SRI	6,505,732	5,930,505	0	12,436,237
Total	$ 252,015,994	$ 44,396,071	$ 7,000,000	$ 303,412,065

* – Actuary's estimate of Title I insurance in force.

Insurance written by Fund during 1988 was $41.3 billion for MMI, $7.3 billion for GI, and $75 million for SRI. The CMHI Fund had no insurance written during 1988.

Section 221(g)4 Program Contingent Liability:

Mortgages insured under Section 221(g)4 of the National Housing Act may be assigned to FHA (GI Fund) by mortgagees in exchange for FHA debentures bearing current interest rates. The assignment of these mortgages to FHA may result in a liability if Treasury-established debenture rates exceed the mortgage interest rates since, in those circumstances, interest paid on the debentures will exceed interest received on the mortgages.

Eligible mortgagees must elect to assign their mortgages to FHA during the 20th year of the mortgage. The fiscal year in which outstanding mortgages under the Section 221(g)4 program reach their 20th year, and thus may become liabilities are presented below for the next five fiscal years and thereafter (dollars in thousands):

Fiscal Year	Projected Principal Balance – Year 20	Average Mortgage Interest Rate
1989	$ 142,873	7.19%
1990	185,477	8.08
1991	293,789	7.62
1992	307,099	7.00
1993	205,254	7.06
Thereafter	1,497,856	9.47
Total	$ 2,632,348	8.56%

Note 12. Commitments and Contingencies (continued):

Section 221(g)4 Program Contingent Liability (continued):

The current Treasury-established debenture rate is 8.625 percent. To the extent Section 221(g)4 mortgages have already been assigned to FHA and have remained current, a discount has been recorded for the difference between the mortgage interest rates and prevailing market interest rates as of the dates of assignment.

HUD's actuary has estimated that the total potential cost to the GI Fund from the Section 221(g)4 assignment option will be $678 million. However, the difficulty of predicting future interest rates creates a potential for large deviations in this estimate. Therefore, the contingent liability, if any, resulting from the Section 221(g)4 program has not yet been recorded in the Consolidated Statement of Financial Position.

Lawsuits and Other:

FHA is party in various legal actions and claims brought by or against it. In the opinion of management and general counsel, the ultimate resolution of these legal actions and claims will not materially affect FHA's financial position at September 30, 1988.

Note 13. Government Equity:

As required by the National Housing Act, the equity of MMI and CMHI are maintained in two separate accounts; the general surplus account and the participating reserve account. The general surplus account is generally available for operating purposes while the participating reserve account is generally used to pay distributive shares to policyholders, although it may also be used for operating purposes if required. Cumulative results of operations are allocated to these two accounts based on actuarially determined operating requirements of the Funds. Cumulative losses of the GI and SRI Funds are partially offset by capital appropriated to these two Funds by Congress.

Note 13. Government Equity (continued):

Following is the composition of government equity for each of FHA's Funds as of September 30, 1988 (dollars in thousands):

	MMI	CMHI	GI	SRI	1988 Total
General (Deficiency) Surplus	$ (378,091)	$ 15,958	$ 0	$ 0	$ (362,133)
Participating Reserve	2,166,970	1,974	0	0	2,168,944
Cumulative Results of Operations	0	0	(6,355,047)	(3,586,634)	(9,941,681)
Appropriated Capital	18,809	0	3,244,391	2,017,647	5,280,847
Equity (Deficiency)	$ 1,807,688	$ 17,932	$ (3,110,656)	$ (1,568,987)	$ (2,854,023)

Following is the composition of government equity for each of FHA's Funds as of September 30, 1987 (dollars in thousands):

	MMI	CMHI	GI	SRI	1987 Total
General Surplus	$ 1,030,506	$ 16,734	$ 0	$ 0	$ 1,047,240
Participating Reserve	2,326,490	1,841	0	0	2,328,331
Cumulative Results of Operations	0	0	(3,784,187)	(3,333,462)	(7,117,649)
Appropriated Capital	18,809	0	2,987,263	1,924,682	4,930,754
Equity (Deficiency)	$ 3,375,805	$ 18,575	$ (796,924)	$ (1,408,780)	$ 1,188,676

Cumulative results of operations (losses) for the GI and SRI Funds exceed appropriated capital even though the National Housing Act, as amended, authorizes appropriations to restore losses. This is because, under generally accepted accounting principles, losses are recognized upon the default of insured mortgages while for budgetary purposes, related appropriated capital cannot be requested or received until assets acquired in claims settlement are sold at a loss. Furthermore, the appropriations do not cover interest expense incurred on borrowings necessary to sustain the Funds' operations until appropriations are received.

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF OPERATIONS AND GOVERNMENT EQUITY (DEFICIENCY)
FOR THE YEAR ENDED SEPTEMBER 30, 1988
(Dollars in Thousands)

	MMI	CMHI	GI	SRI	CONSOL-IDATED
REVENUES:					
Premiums:					
Monthly Premiums	$ 316,643	$ 0	$ 76,005	$ 38,548	$ 431,196
Earned Portion of One-time and Annual Premiums	1,171,870	2,671	232,967	36,885	1,444,393
Net Premiums Earned	1,488,513	2,671	308,972	75,433	1,875,589
Interest Income	588,386	1,249	102,485	29,611	721,731
Other Revenues	17,871	0	43,555	5,768	67,194
Total Revenues	2,094,770	3,920	455,012	110,812	2,664,514
EXPENSES:					
Net Increase in Loss Reserves	1,246,511	0	2,052,783	64,314	3,363,608
Realized Losses on Sales of Properties	1,692,275	0	279,016	102,383	2,073,674
Provision for Losses on Properties Owned	230,969	0	33,489	7,348	271,806
Provision for Losses on Mortgage Notes Held	61,809	0	228,898	(249)	290,458
Salary and Administrative Expenses	228,763	1,077	203,005	22,368	455,213
Interest Expense	0	19	174,178	164,431	338,628
Other Expense	43,039	191	54,503	3,389	101,122
Total Expenses	3,503,366	1,287	3,025,872	363,984	6,894,509
Excess (Deficiency/Losses) of Revenues over Expenses	(1,408,596)	2,633	(2,570,860)	(253,172)	(4,229,995)
Government Equity (Deficiency), Beginning of Year	3,375,805	18,575	(796,924)	(1,408,780)	1,188,676
Appropriations	0	0	257,128	92,965	350,093
Distributive Shares Paid	(159,521)	(3,276)	0	0	(162,797)
Government Equity (Deficiency), End of Year	$ 1,807,688	$ 17,932	$ (3,110,656)	$ (1,568,987)	$ (2,854,023)

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF FINANCIAL POSITION
SEPTEMBER 30, 1988
(Dollars in Thousands)

ASSETS:	MMI	CMHI	GI	SRI	CONSOL-IDATED
Fund Balance with the U.S. Treasury	$ 32,905	$ 1,398	$ 65,931	$ 12,874	$ 113,108
Investments in U.S. Government Securities Principally Non-marketable	6,193,987	14,017	0	0	6,208,004
Foreclosed Property Held for Sale, Net	1,489,080	0	173,786	33,498	1,696,364
Mortgage Notes Receivable, Net	1,037,511	4,193	1,429,530	441,893	2,913,127
Appropriations Receivable	0	0	418,261	169,552	587,813
Other Assets and Receivables	185,349	1,226	81,744	20	268,339
Total Assets	$ 8,938,832	$ 20,834	$ 2,169,252	$ 657,837	$ 11,786,755
LIABILITIES AND GOVERNMENT EQUITY:					
Claims Payable	363,395	0	251,652	13,645	628,692
Loss Reserves	2,664,000	0	2,610,000	137,000	5,411,000
Unearned Premiums	3,877,683	1,140	99,838	16,007	3,994,668
Debentures Issued to Claimants	31	1,389	118,125	0	119,545
Accounts Payable, Accrued Expenses and Other Liabilities	83,915	360	164,025	103,172	351,472
Distributive Shares and Premium Refunds Payable	142,120	13	0	0	142,133
Borrowings from the U.S. Treasury	0	0	2,056,268	1,937,000	3,993,268
Elimination of Interfund Balances	0	0	(20,000)	20,000	0
Total Liabilities	7,131,144	2,902	5,279,908	2,226,824	14,640,778
Government Equity (Deficiency):					
Mutual Funds Equity	1,788,879	17,932	0	0	1,806,811
Subsidized Funds Cumulative Losses	0	0	(6,355,047)	(3,586,634)	(9,941,681)
Appropriated Capital	18,809	0	3,244,391	2,017,647	5,280,847
Total Government Equity (Deficiency)	1,807,688	17,932	(3,110,656)	(1,568,987)	(2,854,023)
Total Liabilities and Government Equity	$ 8,938,832	$ 20,834	$ 2,169,252	$ 657,837	$ 11,786,755

FEDERAL HOUSING ADMINISTRATION
(A FUND OF THE DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT)
CONSOLIDATING STATEMENT OF CASH FLOWS
SEPTEMBER 30, 1988
(Dollars in Thousands)

	MMI	CMHI	GI	SRI	CONSOL-IDATED
Net Cash Flows from Operating Activities:					
Excess (Deficiency/Losses) of Revenues over Expenses	$ (1,408,596)	$ 2,633	$ (2,570,860)	$ (253,172)	$ (4,229,995)
Non Cash Expenses, Revenues, Losses and Gains Included in Operations:					
Realized Losses on Sales of Properties	1,692,275	0	279,016	102,383	2,073,674
Net Increase in Loss Reserves	1,246,511	0	2,052,783	64,314	3,363,608
Premiums Earned	(1,171,870)	(2,671)	(232,967)	(36,885)	(1,444,393)
Increase in Loss Allowances on Properties and Mortgages	292,778	0	262,387	7,099	562,264
Decrease in Other Assets	64,087	503	57,287	47,415	169,292
Increase in Claims Payable and Other Liabilities	8,580	64	114,931	20,030	143,605
Amortization of Discounts on Investments and Notes	11,477	82	(7,767)	149	3,941
Assets Acquired in Claims Settlement	(5,164,237)	0	(1,140,929)	(201,328)	(6,506,494)
Collections of Principal on Notes Acquired in Claims Settlement	70,114	413	81,351	65,922	217,800
Proceeds from Disposition of Assets Acquired in Claims Settlement	2,824,494	0	190,248	70,127	3,084,869
Premiums Collected	1,345,513	2,267	208,420	32,611	1,588,811
Premiums Refunded	(133,496)	0	(3)	0	(133,499)
Net Cash (Used) Provided by Operations	(322,370)	3,291	(706,103)	(81,335)	(1,106,517)
Cash Flows from Investing Activities:					
Purchase of Investment Securities	(3,156,585)	(24,320)	0	0	(3,180,905)
Proceeds from Sales of Investment Securities	3,569,630	23,308	29,390	0	3,622,328
Issuance of Purchase Money Mortgages	0	0	0	(3,428)	(3,428)
Collections of Principal on Purchase Money Mortgages	30,038	2	67,767	6,836	104,643
Proceeds from Disposal of Purchase Money Mortgages	0	0	95,944	0	95,944
Net Cash Provided (Used) by Investing Activities	443,083	(1,010)	193,101	3,408	638,582
Cash Flows from Financing Activities:					
Appropriations Received	0	0	113,540	49,326	162,866
Borrowings from the U.S. Treasury	0	0	460,000	220,000	680,000
Issuance of Debentures to Claimants	0	0	48,877	0	48,877
Payment of Borrowings to the U.S. Treasury	0	0	0	(218,166)	(218,166)
Payment of Debentures	0	0	(105,068)	0	(105,068)
Distributive Shares Paid	(159,522)	(3,275)	0	0	(162,797)
Net Cash (Used) Provided by Financing Activities	(159,522)	(3,275)	517,349	51,160	405,712
Net Increase (Decrease) in Cash	$ (38,809)	$ (994)	$ 4,347	$ (26,767)	$ (62,223)

Senator CRANSTON. Thank you very much for your very helpful, constructive testimony.

Chairman Riegle of the full committee is now with us. Do you have any opening remarks to make?

OPENING COMMENTS OF SENATOR RIEGLE

Senator RIEGLE. Only this, Mr. Chairman, that I think this is a very important topic, and I think that these recommendations are persuasive in terms of many of the things just cited, including the annual audit that would sum up all of any outstanding problem areas and the progress made.

I am very distressed, by the way, as to what you have found with respect to the difficulty of even getting an accurate fix on what is out there. We cannot allow that to continue.

It would be my intention to see that we take the steps necessary to make sure that we know exactly what is going on.

Thank you, Mr. Chairman.

Senator CRANSTON. Thank you, Don.

Mr. Bowsher, your testimony obviously raises many urgent questions. My two overriding questions are how could this have happened and what can we do to stop the hemorrhage and rebuild FHA?

I know that Secretary Kemp and Austin Fitts have undertaken, as you indicate, some appropriate steps we have to explore. Hopefully, they will meet our needs and understand more of the background.

What I really want to try to accomplish this morning is to give the subcommittee a full and balanced explanation of your report with your help and the help of the other witnesses.

I would like to ask you to start by describing the effort that produced this report.

When did work on the current audit begin? How many people were involved in the effort?

Mr. BOWSHER. We really have had two audits done here. We had the 1987 audit, which we were able to report to you in the August hearings, that really gave us the opening balance sheet. 10 people were involved in that effort from October 1987 to August 1988. In the 1988 audit, which was a complete audit for the whole statement of operations, balance sheet, and cash flow, statement of internal controls, there were about 10 to 20 people involved in that, which really started in January 1989 and just got completed here in the last few days.

Senator CRANSTON. What led GAO to undertake such a major effort?

Mr. BOWSHER. Well, the Government Corporation Control Act requires that Government corporations be audited. We have been trying to get HUD to have adequate financial information so that we could do an audit for some time. We told them in the early 1980's that we could not do an audit any more because conditions were so bad. They finally took action, I would say, starting in 1985–1986 to start improving their systems. In 1987 we thought the conditions were such that we could start to go back in and try to do an audit. We started with the balance sheet audit for fiscal year 1987.

In other words, we saw the need for this all through the 1980's. It was just that until they got their systems in better shape we couldn't really do anything.

Senator CRANSTON. 15 years seems like an incredibly long time for GAO to have been unable to complete an acceptable audit of such an important agency as FHA.

Before the project was started, what did GAO do to get accurate financial statements for and from FHA?

Mr. BOWSHER. It was virtually impossible. In other words, we received the statements every year, but we felt that they were not auditable. We did a management review in 1984, and I think it was out of that management review that we urged very strongly for the need for improving the systems and getting back to an annual audit. I think that is when they started taking action.

So I think it was our management review in 1984 that finally got people convinced that something had to be done.

Senator CRANSTON. This audit differs from earlier audits in that it looks at FHA activity on the basis of accrual accounting rather than on a cash basis of accounting. It also applies generally accepted accounting principles.

Since these distinctions are important and we have heard conflicting reports of FHA's financial position, would you describe the major differences briefly between those methods and what are the benefits of the methods that you have used in this audit?

Mr. BOWSHER. Actually, Mr. Chairman, the audits have always been on a generally accepted accounting principles basis, but we were not able to give an opinion in the 1970's when we did the audits. We have always looked at FHA on an accrual or generally accepted accounting principles basis.

The Government itself is on a cash basis, obligation basis for budgeting. For budgeting purposes, people look on a cash basis as to where things stand.

The industry and the Government Corporation Act call for accrual accounting and generally accepted accounting principles.

That is how we have always looked at it and done our audits.

Senator CRANSTON. We are going to want to go through the findings in some detail and focus on how these enormous losses could have happened, but I think to help get matters in perspective it might be well now to hear from you, Austin, and hear your opening statement first, and then we will go on to more questions.

STATEMENT OF C. AUSTIN FITTS, ASSISTANT SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, WASHINGTON, DC, ACCOMPANIED BY RUSS DAVIS, SPECIAL ASSISTANT; AND RON ROSENFELD, DEPUTY ASSISTANT SECRETARY FOR SINGLE FAMILY

Ms. FITTS. I would like to thank the members of the committee, Senator D'Amato—I see Senator Pressler has joined us—and also Chairman Riegle. Thank you for joining us today.

I would like to thank you for once again inviting me to discuss the financial condition of the Federal Housing Administration.

I am also pleased to be appearing on the same panel with the Comptroller General, Mr. Bowsher, of the General Accounting Office and the representatives of Price Waterhouse.

You should know that they have done, in our opinion, an excellent job, and they have made our job considerably easier.

Mr. Bowsher has met with the Secretary and his staff, and the representatives of Price Waterhouse have met and worked with many of our staff. We look forward to working with them in the future.

Mr. Chairman, I would like to keep my remarks brief so that we may get to questions and answers.

To begin with, we acknowledge that FHA has incurred substantial losses in virtually every program. When the Secretary first took charge at HUD, he announced his intention to uncover every possible problem. We have been diligent in our efforts to turn over every stone and examine everything that we find.

As part of this effort, GAO and Price Waterhouse have had our full cooperation, and we have turned over all of our findings to them in their efforts.

While losses have been extremely heavy, we believe that the financial statements present a fair statement of the fund as of the end of fiscal year 1988, that the bad news is now out on the table.

While the situation is serious, we believe that the problems of FHA are manageable and fixable, and we are committed to solving these problems.

Our remedial actions at FHA began early in the Secretary's term. There have been three distinct phases so far.

The first priority was to quickly stop the largest financial losses. These included steps in certain programs, including coinsurance that we have talked about already. We believe these actions have arrested most of the immediate dangers.

Following the emergency actions, we focused secondly on the basic financial and managerial needs. These actions were summarized in the Secretary's "FHA in the 1990s" initiative, which we announced before this committee in August. We are now nearing completion of our initial evaluations on phase 3.

Secretary Kemp will soon be discussing a wide variety of further reforms resulting from certain internal studies. However, this is an ongoing process. As other internal studies of FHA's operations are completed, we will be able to propose even additional reforms.

The Federal Housing Administration is extremely important as the centerpiece of HUD's housing policy under Secretary Kemp, and with that in mind, I would like to again quote from the initiative we presented to you and the committee in August from "FHA in the 1990s," and I read from our letter to you, Senator Cranston.

Mr. Chairman, as you begin your review of FHA, it is important for the American people to understand that no home owner or lender need fear any detrimental effects on their ability to rely on FHA. FHA is one of this Government's great success stories and remains the cornerstone of America's national housing policy.

Today, over 9 million American families live in FHA-insured homes. Every year up to 900,000 home buyers realize their dream through FHA.

I want to assure you, Mr. Chairman, and the American people that the Bush Administration is committed to safeguarding FHA's financial health and continued success at no cost to the taxpayer.

Mr. Chairman and members of the committee, I would like to again thank you for holding these important hearings. This is but another example of your passionate commitment to the goal of decent safe and affordable housing. I hope that we could work together as partners on this matter and that in the near future we can put reform behind us and discuss new housing initiatives.

Now, finally, before I turn over to questions and answers, one of the things I do want to add is that, as Mr. Bowsher stated, the Secretary has recruited some truly outstanding members to the team at HUD, with the kind of qualifications that we need to help solve many of the problems in front of us, particularly people with housing and financial expertise.

Two of them are with me here today, and I would like to introduce them.

One is Mr. Ron Rosenfeld, new Deputy Assistant Secretary for Single Family.

Ron?

Mr. Rosenfeld has a very long and distinguished career in both the housing and finance industry. Before he joined us, he was an executive committee partner with Prescott, Ball & Turben.

Also with me is my special assistant Russ Davis, who comes from Wall Street. I would point out that he was the youngest vice president in the history of Dillon Reid, with quite an extraordinary background in finance and financial problems on Wall Street.

So they are with me here today.

Again, thank you very much for holding these hearings, and let me thank you and let's go to questions and answers.

Senator CRANSTON. I thank you a great deal.

[The complete prepared statement of C. Austin Fitts follows:]

Statement of C. Austin Fitts

Assistant Secretary for Housing - Federal Housing Commissioner

before the Senate Housing Subcommittee, Senate Committee on Banking, Housing and Urban Affairs

September 27, 1989

Mr. Chairman and members of the Committee, I would like to thank you for once again inviting me to discuss the financial condition of the Federal Housing Authority. Mr. Chairman, I appreciate the fact that you have devoted your attention to the details of an extremely complex problem. This will help to ensure that our solutions will be lasting and preserve FHA's place as a source of housing opportunity for low and middle income families.

As Secretary Kemp indicated in his August 3, letter to this committee, FHA has been one of this country's most valuable tools for increasing homeownership opportunities. The Bush Administration and Secretary Kemp are committed to working to fix the problems at FHA and moving forward to increase housing opportunity in the U.S.

I am also pleased to be appearing on the same panel with Comptroller General Bowsher of the General Accounting Office and

representatives of Price Waterhouse. They have done an excellent job and have made our job considerably easier. We look forward to working with them in the future.

Mr. Chairman, I will keep my remarks brief so that we may get to questions and answers.

FHA Financial Condition

To begin with, we acknowledge that FHA has incurred substantial losses in virtually every program. When he first took charge at HUD, Secretary Kemp announced his intention to uncover every possible problem at HUD. We have been diligent in our efforts to turn over every stone and examine everything we find. As part of this, GAO and Price Waterhouse have had our full cooperation in their efforts.

While losses have been extremely heavy, we believe that the financial statements present a fair statement of the Fund's as of the end of Fiscal Year 1988, that the bad news is now out on the table. While the situation is serious, we believe that the problems of FHA are manageable and fixable. We are committed to soving these problems.

I think that it is important to distinguish between the finances of the two active funds. The Mutual Mortgage Insurance Fund - which supports the single-family insurance funds - still

has a positive equity status, with over $1.8 billion in equity and over $7 billion in reserve assets. The General Insurance - which largely reflects coinsurance, hospital losses, and accrued claims - has fallen farther into a deficit than it has for the previous ten years.

We believe it is misleading to consolidate the financial results of these two funds, and two which are essentially inactive, for presentation purposes. The four insurance funds operate under separate statutory structures (two mutual funds and two general funds) and are designed by Congress to operate under different financial priorities. We would prefer that the funds be discussed separately.

Reform Actions

Our remedial actions at FHA began early in Secretary Kemp's term. There have been three distinct phases so far. The first priority was to quickly stop the largest financial losses: steps taken include our actions on such programs as coinsurance, Title X, and Retirement Service Centers. We believe these actions arrested the most immediate dangers.

Following the emergency action, we focused secondly on the basic financial and managerial needs. These actions were summarized in Secretary Kemp's "FHA for the 90's" initiative announced before this committee in August. The principal

requirements of this package are annual financial audits, a full actuarial review, and a review of program requirements and participation standards.

We are now nearing completion with our initial evaluations on phase three. Secretary Kemp will soon be discussing a wide variety of further reforms resulting from these internal studies. As this effort is not fully finalized, I would like to defer discussion of specific proposals until the Secretary's announcement. This is an ongoing process. As other internal studies of FHA's operations are completed, we will be able to propose other reforms that are needed.

Commitment To FHA

The Federal Housing Administration is extremely important as a centerpiece of HUD's housing policy under Secretary Kemp. Homeownership and affordable housing, in fact, is the highest priority on the list of his six priority objectives for the Department.

Every year almost half a million to a million families purchase their first home through FHA insurance programs. And FHA will be particularly valuable as the scarcity of federal dollars for subsidies creates an even greater need for [illegible], private sector partnerships, and state and local participation.

Mr. Chairman and members of the Committee, I would again like to thank you for holding these important hearings. This is but another example of your passionate commitment to the goal of decent, safe and affordable housing. I hope that in the near future we can put reform behind us and discuss new housing initiatives.

Senator CRANSTON. Now, I think we should try to walk through the findings in some detail, focusing on how these losses could have happened and how to keep this from happening again.

I would like to ask each of you to focus one at a time on each of the major funds within FHA and describe what has been going on.

The first fund is the Mutual Mortgage Insurance Fund. That is the primary source of insurance for single family homeownership. It is intended to be self-sustaining or actuarially sound, but it lost $1.4 billion.

So I would like to ask each of you to address the following questions as you see fit, starting with Mr. Bowsher and then others add whatever you think should be added or subtracted from what he says.

In detail, would you explain what external factors outside of HUD's control contributed to this loss?

EXTERNAL FACTORS THAT CONTRIBUTED TO LOSS

Mr. BOWSHER. Well, I think two or three factors contributed. One, there is no question that the general economic problems in some parts of our country, such as in the "Oil Patch" and in particular, region VI and region VIII of the FHA, were an external factor that was a major contributor to the problems. In other words, that is where a lot of the defaults are happening.

The second factor is the third party reliance without proper monitoring. That has to be corrected. To get on top of it, you have to have the financial information to know what is happening out there.

Senator CRANSTON. Do any others of you want to add anything to that response?

[No response.]

Senator CRANSTON. If not, what flaws in policy or program design were major factors in the loss?

Mr. BOWSHER. In the MMI Fund, the major factors were the additional defaults that were occurring. In the GI Fund it was the coinsurance and the concentration there that started to cause us major problems. The major losses are from these factors.

Senator CRANSTON. What were the major weaknesses in management—and please be specific—not only about faulty practices, but also about problems in the structure of FHA?

Mr. BOWSHER. As you pointed out, Mr. Chairman, in your opening statement, we have had an organization here that has been cut in staff. If you don't have adequate numbers and adequate quality of people, then you are not going to have management on top of programs. Sometimes I think people in Government have the idea that if you have a 20-percent coinsurance in there that that will make everybody have the right incentives and will keep everything working right. I think you have to monitor programs. I think you have to know what is going on, and I think that was the major weakness in the management here. They just didn't know what was happening.

Senator CRANSTON. Any other comments?

Ms. FITTS. Let me run through the two funds and answer some of those questions.

As to the MMI, I would like to say a few things about the policy and program design. While we agree that monitoring was insufficient, we would also feel that it is extremely important to be very careful about who you let into your programs. It is much easier to monitor if you are more stringent about qualifications and admitting participants to programs.

I think that is true on the MMI Fund. It is substantially more true on the General Insurance Fund, particularly in coinsurance.

The Comptroller General mentioned the importance of timely financial information.

I would add that the reason that is important is that we have not been as responsive as we should be to places and occurrences of loss. If you have that information and are prepared with the regional underwriting standards or other remedial actions to take action, we could have stemmed losses much more quickly.

On the general fund, let me mention again the importance of qualities of standards of who you let into the program. Particularly, it is very important to apply discipline on coinsurance. We have the regulatory basis to either suspend or probate many people who should have been. You have to have the will to do that.

Senator RIEGLE. Could I ask a question at that point? Why wasn't that done?

Ms. FITTS. I cannot tell you, Mr. Chairman.

Senator RIEGLE. Have you asked the people who are in charge?

Ms. FITTS. I have. Frankly, in many instances, I do not think that they had the timely information or the expertise to do it.

Senator RIEGLE. And that is the whole reason? That is 100 percent of the reason?

Ms. FITTS. No, it's not the only reason.

Senator RIEGLE. What is the rest of the reason? What else was at play?

Ms. FITTS. I think, from what we can see in the one situation of DRG, that a great deal of pressure was put on the staff, was put on a variety of appointees. But frankly, I would say that the most critical element that I can see is the failure to disclose financial results of the program or the participants in the program.

Senator RIEGLE. But when you say pressure was put on the appointees, what do you mean by that?

Ms. FITTS. I am talking strictly from the stories that I have read, that are the same stories I read in the paper, that a great deal of effort was made by the company, either during hearings at FHA or with a variety of people in charge of the program, to listen to their case.

Senator RIEGLE. We can come back to that. Excuse me. Thank you.

Senator CRANSTON. Don't hesitate, members of the committee, if at any time you want to come in with a question. Just do it.

Ms. FITTS. And this gets into something that Chairman Riegle I think properly brought out. Another issue, particularly in the general fund, is it's imperative, if we are going to run highly complex financial programs in Government, that we make provisions to specialize expertise to handle them.

I don't think that was done sufficiently in coinsurance. But two other examples which you have heard about—not today, but in pre-

vious times—the retirement service centers and title X also, for reasons that the Comptroller General mentioned—there was a focus by the program people on production without a measurement of the cost benefits of that production, really because there was no integration between financial systems and financial results with underwriting results. Two good examples again of that are title X and retirement service centers.

On the management issue, I would like to add one additional thing. I think this came out in our testimony in August, but I cannot stress it enough. This goes in fact to the first point that GAO made—has made here up on the chart, which I believe is an excellent one. That is the problem of the turnover in senior management.

I believe, in my position alone, in the last 8 years, seven people held that position, either as acting or confirmed. Not only that, they did not pick many of the people who worked for them. Consequently, you had not only an absence of an ability to develop a strategic plan or management plan with milestones, but the absence of really an environment—and an environment where not only was it difficult to have policy formulation, but then to discipline.

One of the things the Secretary put great importance on when he staffed not only the agency but in particular the FHA was that a team of people would be chosen with expertise specifically designed for the problems that he first saw; that they be hired as a team together; that they interviewed each other; and that all of them were required to make a commitment through 1992.

Senator CRANSTON. Senator D'Amato has a couple of follow-up questions.

Senator D'AMATO. I would like to ask the Housing Commissioner, because I think many people are raising the question, "Is this another FSLIC situation?", Commissioner, would you distinguish for us the difference between the FHA problems and those which we have seen with FSLIC? What is taking place?

PROBLEMS OF FHA AS IT RELATES TO FSLIC

Ms. FITTS. Senator, I am extremely glad you asked that question, because there are those that have tried to draw parallels between FHA and FSLIC. In certain instances, they have done that in what I consider to be a most irresponsible fashion.

There are several differences, and I would like to talk about five of them. First of all, in the situation of FSLIC, you had a government fund that was in essence insuring deposits on a system that the Government regulated but not controlled. What we are talking about here is a Federal agency, which is very much under the control of the Federal Government. That is No. 1. That certainly makes it much easier to monitor, and much easier to fix.

No. 2, one of the greatest risks at FSLIC, and one that made it very hard to manage over time, was interest rate risk, as opposed to credit risk. The problem that the S&L's faced was one of funding long-term obligations with short-term liabilities. We do not face that at FHA.

Our situation in FHA is one of credit risks. In many instances—it is particularly in the MMI fund that I would like to point out that those are not speculative loans, as was the case with S&L's. What we are talking about is American home owners across the country.

I would submit to you that those people are taxpayers and workers; that the collateral that we hold is their homes. If we do not value that credit, then I submit to you that we do not value the credit of the U.S. Treasury, because certainly that is a portion of the same credit that backs us all.

Another thing, point four that I would like to point out is the size of the FSLIC situation, which was far larger. No matter what we think our problems are here, they are eminently smaller.

Finally, I would like to say that, thanks to the work of this committee, thanks to the work of GAO, and now thanks to Secretary Kemp and George Bush, whatever our problems are they are being nipped in the bud. If early on in a problem FSLIC had been faced squarely the way I think this has been, certainly it would have been far easier to cope with that one.

I will say this, and this is the one negative that I would add. The Secretary will be coming forth with reforms. We have proposed other reforms in the FHA in the 1990's. Without many of those reforms, it will be difficult to stem these losses.

So whereas we say the situation is eminently manageable and eminently fixable, it is not without your help, and it will take a tremendous amount of will, both on the part of the administration and the Congress.

Senator D'AMATO. I hope that this question is not premature, but it certainly is one that I believe the American people have and those of us in the Congress, as we begin to learn the dimensions, the scope, and the manner in which some of these problems have occurred, as a result of there being little if anything in the way of managerial supervision. And that would be apparent by way of your comments and Mr. Bowsher's.

It would seem that we were lax, to put it mildly. What changes have you and your staff considered, as it relates to placing controls on the operations of the insurance funds? I am not suggesting that you give us a detailed report at this time, but I think that it is a nagging question that we all have to face.

CHANGES IN CONTROLS ON THE OPERATION OF THE INSURANCE FUNDS

Ms. FITTS. Let me mention a few of the things that we have done today, and some of the things that we are considering to determine exactly what must be done. As I mentioned in my opening statement, there are emergency steps that had to be taken to stop what we have referred to as the hemorrhaging. I can go into detail if you want on the many steps that we have taken on coinsurance.

I am very glad to see that GAO mentioned an evaluation of the coinsurance capitalization requirements. We have had an outside, independent accounting firm, in fact, Price Waterhouse as well, do an analysis of capital requirements on the program.

As you know, we are proposing that we terminate title X through rulemaking, which has been a program that has lost us a

great deal of money, and which we believe has provided very, very few benefits for low- and moderate-income Americans.

We have put a moratorium on the retirement service center program. Our policy development research shop is studying that. We have taken several steps to try and minimize our exposure on the hospital portfolio, which we are extremely concerned about.

Those are some of the steps that we have taken on the hemorrhaging. At FHA in the 1990's, the Secretary announced that he would institute audited financial statements, and from 1990 on we will be announcing our financial results on both the cash and accrual basis. The accrual basis will be independently, annually audited. Those will be delivered to this committee and Congress.

I think a very important point is that the results are not in. We are in the process of instituting a major actuarial study. That study is to do several things. One is to test the soundness of both the MMI and the GI fund. The second is to study what the impact on the actuarial soundness of the fund in the future would be by the change of various terms and conditions in the insurance policies we write.

Finally, it is the hope that out of that study we will develop an econometric model that, as a tool, we can use in our planning process on an ongoing basis to test the soundness of the fund and to look at what the terms and conditions on insurance should be.

Finally, I pointed out earlier the importance of the management plan. We have instituted a strategic planning process, and hope before the end of this calendar year to have in place a 4 year strategic plan that will back into a 1 year plan and a 3 month plan.

I said again in my statement that the Secretary plans, hopefully in the near future, to announce additional reforms, and that other reforms will be forthcoming when we have the actuarial study.

Let me mention one other thing. GAO has talked about the establishment of a chief financial officer at HUD and a comptroller at FHA. We have looked very carefully at the problem, and we discussed it in this committee in August, the problem of the failure of programs to be financially accountable, and the problem of the accounting systems reporting in one direction and the programs being reported in another.

We are in the process of studying how to make those two accountable. We are considering GAO's recommendations on this point.

Senator D'AMATO. Mr. Bowsher, could you tell us, in your analysis, have you projected whether or not we have peaked regarding single family losses? Do you have any indications as to what that may be?

Mr. BOWSHER. We have not projected, but we did note that it seems to be plateauing somewhat. In other words, the increase is not rising quite as fast. I would think that, if the economy stays strong, we might have seen the worst of our problem.

But I don't think that we should kid ourselves that we don't have quite a few defaults still coming in here. That is one of the things that worries us.

Senator D'AMATO. Let me ask two other questions. Did your audit indicate that part of the problem, in addition to the economic problems that a region might face, such as the Oil Patch area or

vast numbers of job dislocations, et cetera—that would dramatically impact the mortgage defaults. Was there any indication that the credit checks and worthiness of the applicants was not sufficient?

Mr. BOWSHER. There was some of that. There were also some problems in appraisals and things like that. What you have here is, again getting back to the issue of monitoring, you have got to monitor these programs and make sure that people are managing the programs in a proper manner. We did see some of those problems.

Senator D'AMATO. With the chairman's permission, I would like to ask if you would not, if possible, look at that aspect as it relates to both areas, the appraisal of value, and what can and should and what was not done about seeing to it that there is a creditworthiness. I do not mean to be discouraging brokers, et cetera; but brokers and others who are pushing through applicants and applications that really have no basis and should not under any circumstances be given these mortgages.

I would like to know how much of that has gone on. Is that possible?

Mr. BOWSHER. I think we could. I think that in fact there are some investigations going on right now. What we would do is take a look and see what they are coming up with, and then maybe do some additional work and report back to you.

Senator D'AMATO. Would you do that? I think that would be helpful.

Senator RIEGLE. Could you yield on that point before you move to the next one?

Senator D'AMATO. Sure.

Senator RIEGLE. I appreciate your yielding.

On that point, can you give us a sense as to whether there are intermediaries, people who were facilitating transactions and who were getting financial gain from doing so on the front end of these transactions? In other words, people who were loading up these Government investments, even if they were going out to lots of little individual situations.

Are there people who were middlemen, that were cashing in on what was going on here? What is your reading on that? Can you give me a description as to what kinds of individuals that might be, if there are such?

INTERMEDIARIES TAKING ADVANTAGE OF THE SYSTEM

Mr. BOWSHER. We did not particularly look for that when we were doing the financial audits. In the MMI, you don't have quite the possibility as some of the multifamily situations and in some of the special projects that are funded in the GI Fund.

Again, I think that there are some investigations currently going on that are looking for some of that. It is not the GAO that is doing that.

Senator RIEGLE. Could I just ask Ms. Fitts the same question? In terms of your understanding, do we have, as part of this problem, intermediaries or facilitators who are trying to take and get the Government invested in certain kinds of activities that have now gone sour, where they would have earned fees or front end financial benefits from doing so, in any of these areas?

Ms. FITTS. Chairman Riegle, let me answer on the basis of my experience with the staff for the last 6 months, not only in terms of the work we have done together on some of these programs during that period, but also my questions of them in terms of trying to figure out what to do on these programs and what happened before the Kemp team got there.

My father had a saying. He said, "Never explain by conspiracy what can be explained by inefficiency." I have to tell you that that is what——

Senator RIEGLE. It works two ways. We do not want to explain conspiracy in the name of inefficiency. It is a two-way street.

Ms. FITTS. Absolutely. Absolutely. But what I will tell you again and again and again in a number of areas—and let me use two, coinsurance and title X—what I have found is a staff—first, let me say about this staff one thing. HUD has 13,000 dedicated public servants who are extraordinary. But again and again, they are asked to do highly specialized financial functions, when they are generalists and they have not been trained to do that exact thing.

What I have found consequently, both in the area of coinsurance and in the area of title X, is that they do not have the underwriting skills in many instances, given their workload, to make good assessments.

More importantly, when they do make those assessments, they are not held accountable, and they do not think in terms of results of their underwriting. They are thinking in terms of the importance of putting units out there in the street. I think all of us feel that way.

Senator RIEGLE. You are sidestepping the point I am raising, and I do not want to trespass on Senator D'Amato's time too badly——

Senator CRANSTON. My time, still. [Laughter]

Senator RIEGLE. Senator Cranston's time.

I want to know, given all of the inefficiencies, given the poor management controls, et cetera, were there people nevertheless cashing in on the inefficiency on the front end. That seems to be an answer that is either a "yes" or a "no."

Ms. FITTS. I have not personally had an experience with anybody who is cashing in on anything. I have had experience with staff who make very poor recommendations based on lack of expertise, the failure to feel responsible for financial results.

That is not to say that it did not go on. I was not there at the time.

Senator RIEGLE. No, I am not saying that you were. I am not trying to put it in the present tense. This presumably happened before you arrived, and that is a clear point.

What I am asking you for is a candid answer. You understand enough that went on last year and the year before.

Ms. FITTS. Absolutely.

Senator RIEGLE. Was there any of this, or not? Are you basically saying that this was 99 percent an inefficiency problem, that rip-off artists were not in this system taking advantage of it and milking it?

Ms. FITTS. I cannot tell you. I can give you an example. One of the first things that happened to me during the process—as Secretary Kemp ordered me to do—on turning every stone, I discovered

the title X program, which is a program that is known for tremendous numbers of consultants.

I automatically expected what I think you are getting at. I said to one of the staff people, "You know—" and let me go back. This is a program where we have had an outrageous number of defaults. We have almost a 50-percent default rate. And I said, "Why such a high default rate?" And the staff person, whom I trust very much, said, "One of the people involved in the program would constantly raise the mortgage limit when it was requested." And I said, "Was this because of pressures from consultants?" And they said, "No, the consultants did not have to bother to pressure. Whenever the developer or the principal asked, he was willing to do it. He just did not understand enough about the business to know better."

So that is an example where you say to me, "Was there pressure?", and I could not find any. Now, at the same time, I have asked the Inspector General to investigate and audit that program, including the activities of the consultants. I do not want to take it on the basis of one or two trusted staff members.

Senator RIEGLE. But we will ask him to make absolutely certain that the Inspector General does examine that very carefully.

Ms. FITTS. Absolutely.

Mr. BOWSHER. If I could just add to my answer, Senator Riegle, and that is that my staff reminds me that we are working on a job on the direct endorsement program, looking at some of the organization and some of the appraisal activities. We will have that report in December.

If we were to run into any of the situations that you are talking about here, of external people trying to influence, let's say, decisions in that way, we would probably report that in that report.

IMPACT AND LOSSES ON THE DEFICIT

Senator D'AMATO. Mr. Bowsher, I want to ask one last question before I go to a markup. Would you project for us what the impact and losses of these programs will be on the deficit?

Mr. BOWSHER. If we can go back to our chart over here, you can see that there are two funds that are subsidized funds that you are going to have to appropriate money for. My guess would be that you are going to have to, over the next several years, appropriate somewhere between $4 and $5 billion to make those funds whole.

That is what I would expect the impact on the budget deficit to be.

Senator CRANSTON. They cannot be made whole by their earnings over a period of time?

Mr. BOWSHER. My best judgment would be that you would probably have to have some appropriations, yes.

Senator D'AMATO. Again, I thank the chairman for the courtesy in allowing me the latitude of asking both you and Secretary Fitts questions that I put to them.

I am wondering if you could not come up with some figure estimating what you think we will have to be appropriating in the next several years. Second, I really think it is very important that we ascertain again what proportion of the problem came about as a result of poor credit management, whether or not it was facilitated

by those who were eager for profits in the system—and I am talking about out in the private area, facilitated mortgages; and who packaged them—it is only on that basis that we are going to be able to take remedial action against the culprits who may have broken the law—I would suspect that you would find that that would be the case with the phony figures, et cetera.

If that happens it becomes important to see to it that the FHA is kept sound, made sound, and that we take the remedial action necessary for the future. That becomes absolutely critical. It is important not just to track down the culprits, but also to eliminate that as a problem, and to see to it that we bring the kind of integrity into the program that is absolutely necessary. I would bring that to your attention.

Mr. BOWSHER. We will try to do what we can, Senator. I think you have to recognize, as Senator Riegle well knows, in some of our efforts on the S&L crisis, sometimes the documentation is so poor that it is hard to make a determination as to——

Senator D'AMATO. If you see poor documentation in these areas, then let us know. That would be an indication.

Mr. BOWSHER. It is an indication that you have problems. That is exactly right, and we would do that.

I might just point out that, when I was talking about the amount of moneys for the appropriations, that is what we know now. In other words, if additional losses come in, then the appropriations for those two funds would probably have to be larger.

Senator D'AMATO. Thank you, Mr. Chairman.

Senator CRANSTON. I think this really is a more helpful way to operate than having a rigid 10 minutes for each Senator. We can follow up more easily on things this way.

I would like to thank you also for the very articulate statement of the difference between this situation and FSLIC. The differences are profound, and I hope that the press and all others present will recognize that, according to that analysis, we do not face anything like the possible dimensions of the losses that occurred in the FSLIC thing.

That is the case; is it not?

Ms. FITTS. Yes.

Senator CRANSTON. Mr. Bowsher, again to all of you, obviously there is a huge loss, there are huge losses that are very disturbing. This is following up or asking again in a slightly different way what Senator D'Amato asked you.

What is the outlook? Are we in a freefall here, and to what extent will losses of this magnitude continue until changes are made? How swiftly do the steps that the Secretary and Austin are taking have to be implemented? How fast do we have to move legislatively? Do we have to anticipate further losses until some remedial steps are taken?

Mr. BOWSHER. I do not think we are in a freefall. In other words, I think what we have here is a program that is in trouble. Several billion dollars are involved. I think it is better to have the Administration put a good plan together and bring it forward to the committee, and then for Congress to finance the plan and to put through the legislation for the reforms in an orderly fashion.

Senator CRANSTON. What are the most important—does anyone want to add anything to that?

What are the most important corrective steps that are now being taken, and what are the most effective remedies that remain to be taken? What staffing changes are the most needed? What new skills are most needed?

MOST IMPORTANT STEPS

Mr. BOWSHER. I think the important steps are to get the monitoring and the financial management improvements in there, and of course the management action plan. You have to recognize that we are at the very beginning of all of this effort. So what we have to do is to follow up very carefully here in the next few years.

One of the things that we said in our management review in 1984 was that a lot of things got started at HUD over the years but never got finished. One of the problems goes back to the one that Austin Fitts raised about too much turnover of the senior management.

We saw all kinds of systems, efforts, get started, but the person that started it left within a year. So you have to have continuity of management, leadership; you have to have adequate staff; you have to have quality staff; and you have got to have the needed systems. That takes time, and it takes follow up to make sure that it gets done.

That is really what has to be. I think that is where the role of the Congress must come in.

Senator PRESSLER. Mr. Chairman, may I ask a question on that point? Both Ms. Fitts and you have pointed out that you need quality staff, and that is how you get the job done. The Social Security Administration recently complained that because of government salaries and other problems they are losing a lot of their people who can do financial analysis and similar work.

I know that you can prepare a strategic plan for 4 years, and that is very commendable. I had some experience with McKinsey and Company years ago, and we would develop such plans, but then somebody would have to implement them.

What is the situation—and I turn first to Ms. Fitts—with the staff, with the people who have to make these judgments? You have to have career civil servants, as a matter of public administration. You have to attract them, and keep them.

Is that being done? Are we really losing the people, once they get trained, to private industry? All of the plans that we hear today, everything presented here at this table this morning, is fine. But unless somebody is there to implement it, to carry it out—this is the middle-level career civil servant who is dedicated, well-paid, and so forth—the strategy is failed. What is the situation?

Do you have good people?

LOSS OF QUALITY PEOPLE

Ms. FITTS. Let me go over several points on that question, which is an extremely important one.

One of our highest priorities is what I call long-term personnel management and development, for that very reason. But first, let

me just say one of the great fallacies, and it is a fallacy that I heard many times when I explained to people that I was joining the Department—and that was that all of the good people have left HUD.

That is not true. There is an extraordinary amount of people that I have worked with in the FHA in that Department who are very, very talented, and they give us a nucleus to build around, which is the most important thing if you want to get things done immediately.

We do need incremental additions of certain types of expertise. I know in August Senator Cranston found it amusing when I described the fact that we had a $300 billion portfolio and one actuary. We do need more than one actuary.

These are not budget deficit questions here. I think we have the authority to supplement these very critical areas. Second of all, which is very important to understand, it is very important to specialize to handle some of these programs. The way that HUD has been organized, teams have not been permitted to specialize, so that the current people who could carry the same workload that we do in a much better way can simply be reallocated or their time be reallocated so that they can handle a much larger workload.

Let me give you one example of that. Retirement service centers, which is a very complicated and novel kind of financing mechanism, essentially we required almost every one of our field offices to do it. There is no reason that something like that program, which is a very low-volume program, cannot be run through a limited number of offices. That makes it possible to do the same amount of programs with much more specialization and much fewer losses.

Another example, we have an extremely limited training effort going on where it is essential that the really quality employees in certain areas be training the others. There is tremendous technology available to do that, and there are ways of doing it much more efficiently than we have done, and they do not require large, if any, amounts of incremental revenues to do that.

Finally, what is essential is that we need additional outside expertise in certain areas. For example, we said that we need independent audited financial statements. That is not something that you can do internally. There are other things that I believe must always be done by someone outside the Government.

Sometimes, I often am known to say to the staff, "It takes a fox to catch a fox." In the particularly sophisticated programs, you will always need to be leaning on outside real estate and financial expertise. We need to do more of that.

So there is a whole series of steps that we can take, and they must be taken. That is part of the reform that is necessary if we are going to achieve these things.

Senator PRESSLER. As I understand from the testimony, what you need is a core of people who are CPA's, or who have the abilities, the equivalent ability of CPA's, accountants, and so forth. I was reading this weekend that some of the accounting firms are paying those people $70,000 a year to start, those types of people.

Are you losing good people to the private sector?

Ms. FITTS. It is my understanding that the agency lost a great many over the last 8 years. There are several things to remember. That is, particularly in the financial markets, there was a strong rise in salaries outside of government. There was great effort made to attract by outside institutions. That trend is now turning the other way. That is No. 1.

No. 2, there is a great deal of increased specialization and technology that can be done with much younger people in government, because it offers great responsibility and I think offers opportunities that the private sector may not. An effort has not been made to systematically recruit those, and I think it can.

A third thing I would say is that, for example, we have just been able to recruit one of the people that I knew on Wall Street was one of the top product development people in the finance area. This gentleman is a dedicated public servant. He has the opportunity to go to Wall Street and make far more money than he will ever make with the FHA. Yet, he is one of many people who have decided that public service is what he wants to do. Those people do exist.

Finally, let me add that there is no doubt about it, there is a substantial difference in what we can pay and offer in terms of benefits in the public sector compared to the private sector; which is why I think in some areas we are always going to have to rely on outside expertise to do certain things.

Mr. BOWSHER. Senator Pressler, I think Ms. Fitts has given you a good rundown on HUD. I would just add that, in doing our management reviews of the other departments, we have run into this very point that you have raised. I think it is absolutely a key point as to how well government is going to operate in the future.

When we look at the IRS, we look at an agency that is responsible for the revenue base of the Federal Government; and yet, when we did our management review 2 years ago over there, we saw a distinct trend downward as to the quality of people that they are attracting—lawyers, accountants, systems people.

You are absolutely right. It is important that you have the talent to carry out your management plans. That has got to be done by middle management people who have got to be properly compensated.

The Congress also gave me a special assignment this year, to be chairman of the pay review group for the law enforcement community. I can tell you today that, contrary to 20 years ago, law enforcement positions in the Federal Government are drastically underpaid compared to the Los Angeles police force and some of the local police forces.

We have situations where we are going to expand because of new laws. For example, in the prison system, we are expanding with a staff that used to be 50 percent college graduates. It is down to 20 percent.

So all of these areas, whether you are talking about the IRS or the FAA, the safety of our air transport systems, the social security system, the HUD, and the FHA—I think we are running into a period of real problems. If we cannot attract enough quality people to run the systems and to make the tough decisions on these big program areas, we are going to have problems.

I think it is going to be one of the biggest problems that Congress and the leaders in government and the executive branch will be facing.

Ms. FITTS. Mr. Chairman, could I add one thing to that? I think—and I cannot say this enough, because it has been in my mind literally every hour since I have been at HUD—when you look at this chart and when you look at these losses, think about how little expertise it would have taken, whether inside or outside, and the little cost of that expertise, that could have saved much of these losses, think what a good investment it would have been.

So when you look at pay scales, and when you address these issues, which are really systemic to the Federal Government, I really encourage you to think of that.

Senator CRANSTON. I would like to focus now a bit on the General Insurance Fund, as we did on the Mutual Mortgage Insurance Fund in my earlier questions. It provides insurance, as you well know, for multifamily housing and for a wide variety of activities.

Most of the programs within the fund were designed to involve a subsidy, and losses through insurance were considered the most cost-effective way to provide that subsidy. However, the recent losses are far beyond what Congress expected, or can tolerate.

So please, walk us through that fund as well. First, what external factors contributed to those losses?

GENERAL INSURANCE FUND

Mr. BOWSHER. I think by far the biggest external factor was when DRG and two other coinsurers went into the tank in 1988. Not only did that present all of the problems associated with a major coinsurer going under, but because they were undercapitalized, the Government had to pick up practically the entire loss.

Senator CRANSTON. What brought them down?

Mr. BOWSHER. I think the main factor was that they were thinly capitalized. Once some of their coinsurance did not go well, they went under.

Senator CRANSTON. What were the most significant failures of program design or policy? You mentioned coinsurance and hospital insurance. If you would go into those in a little more detail, I would appreciate it. How could those losses have happened?

Mr. BOWSHER. Well, you have to recognize in the hospital area that the FHA is basically the lender of last resort. What you are doing is picking up the more risky loans, compared to what some of the people in the private sector would be willing to loan.

But again, I think this is an area that needs a good deal of thought on the policy issue and the design of the program. What you have allowed to happen here, I am afraid, in the last few years, is to have programs where people in the private sector are highly leveraged. Therefore, their risk is quite great if anything happens to the general economy. I think that is what has happened here.

This is an area that really should be looked at very carefully to see if program and policy changes should not be effected. I think that with what happened in 1988, we have potential problems in the next few years if nothing is done about it. I think this is an important area to look at.

Senator CRANSTON. What are the most significant weaknesses in management practices or structure?

Mr. BOWSHER. It is monitoring and having the right financial information. You have to have information on a program level and on a regional level, to know what is happening and to be able to take action.

Senator CRANSTON. What are the most important corrective steps that are now being taken? What remains to be taken? What staffing changes are needed beyond those you have already talked about generally, and what new skills?

Mr. BOWSHER. I think Ms. Fitts could answer that best, as to where things stand right now.

Senator CRANSTON. Is there anything you can add on this?

Ms. FITTS. I covered some of the things we have done. Let me talk about what else needs to be done. Obviously, much of it is subject to the results of the actuarial study. As I said, there are a great deal of specific steps that will be announced by the Secretary in his reform package.

In general, let me just review a couple. We have talked about expertise. I think that expertise needs to be slotted in areas that will really help us define quickly what our risk is. That goes to management information systems and financial information systems.

That leads me to the question again of information systems. We need to manage and design those. Very importantly, we have to redesign the management scheme at FHA so that managers not only are accountable, but have the resources necessary to be held accountable.

That goes back, I think, to integration of the program and the financial systems. Obviously, we have to redesign faulty programs. There are structural flaws in coinsurance and retirement service centers and others. Those structural flaws have to be addressed.

In "FHA in the 1990's," we have talked about technology. We have not integrated technology properly into the program areas. That technology can help monitor much more effectively, and also increase the productivity of the people there.

We have talked a lot today about monitoring. I think it is, again, very important to understand how important it is, who you are doing business with, what the standards are of who you let into your programs. We have to make doing business with the FHA a privilege, not a right. If you have higher-quality standards to entrance into the programs, then monitoring becomes an easier job.

Finally, this leads me to the last point. That is that we in our programs have to improve our products and our services, so that the right kind of financial institutions and other participants will find it professional to handle our programs and to do business with us. That is critical, if we are going to attract those kinds of institutions.

Senator CRANSTON. The GI Fund contains more programs than the coinsurance program. I know the source of losses in this fund is contained in the hospital insurance programs. Some argue that the losses in the insurance program are due to external conditions that affect occupancy rates.

HUD cannot be expected to predict occupancy rates in hospitals. So why is the hospital insurance program contained in the FHA

funds, and what is the relationship between HUD and HHS in deciding what hospitals to insure?

Mr. CRAREN. I can take that, if you like, Mr. Chairman. The Department of Health and Human Services is responsible for the underwriting and in addition, for determining where hospitals should be. There is a certificate of need that is requested and filed. But if there happens to be poor underwriting, it is HUD that bears the loss.

One of the comments we made is that that is also a split between those who are really responsible for endorsing the mortgage and those who have to pay for it. It is reflected in FHA's numbers now, perhaps unfairly. I think they have less control over it than they should.

They have no control over occupancy or the underwriting, and probably not the expertise now to do it if they had to.

SHORT-TERM ACTIONS TAKEN

Ms. FITTS. Let me review some of the short-term actions we have taken, Mr. Chairman. Part of the problem in the hospital program is that a substantial amount of that portfolio is located in one State. As the cost containment provisions in the Medicare system have been tightened, it has caused systemic problems throughout the Nation in hospital credits, but particularly in one State, which is New York State. So in a sense, it is a systemic problem affecting a wide range of large hospital systems.

What we have done in the interim is, we are in the process of hiring someone to check all underwritings, even though that work, theoretically or technically, is supposed to be done by HHS. We have hired an outside consulting firm to support that person and review all underwritings in the pipeline, and are doing that.

However, we do consider those to be short-term measures, simply to protect the liabilities we take on in the near future.

Mr. BOWSHER. I think the only thing I would add, Mr. Chairman, is that we are all aware that we have occupancy problems in many hospitals throughout this country. It is one of the areas that GAO is doing quite a bit of work on for other committees.

So I think that the potential for problems in this area probably will continue.

Senator CRANSTON. Mr. Bowsher, Mr. Craren, and also Ms. Fitts, both GAO and Price Waterhouse came up with a disturbing conclusion that even after 2 years of effort you cannot express an opinion on the accuracy of FHA's financial statements. You indicate the losses may be even greater than those that you have found fit to report this morning.

I would like to ask if you would answer this. What is being done to get answers to the still unresolved questions, and when will those answers be forthcoming?

FHA'S FINANCIAL STATEMENTS

Mr. CRAREN. One of the major problems we had, Mr. Chairman, is trying to deal with the number of investigations that are going on right now that we don't have privy to and trying to assess what possible impact they could have on the FHA fund.

We don't know what the prior administration may have done that could have caused problems.

We don't know the extent of the property diversions. We don't know how many Robin HUD's there could be.

So it is difficult to assess how many more losses could take place there.

Also, we are concerned about the capital requirements, as the Comptroller General mentioned. Our feeling is that there is the possibility that more coinsurers could go into default and cause additional losses, and it is difficult for us to predict, as is the resolution of the other legal matters.

So until those are resolved, I think that we are always going to have a problem rendering any sort of an opinion on FHA.

Senator CRANSTON. Do you have anything to add?

Mr. BOWSHER. I would add that I think it also shows the importance of having annual financial audits. If you keep working on these situations, I would hope that at some point in the future once we get the problems cleared up, we could give an unqualified opinion. Once we can achieve that, Congress will have a great deal more sense of where things stand.

That is why it is absolutely essential to keep having annual financial audits.

Senator CRANSTON. Can you give any estimates—we have already touched on this—of how much greater the losses could be, and could you tell us what are the most troublesome sources of potential additional losses?

Mr. BOWSHER. Tom basically summarized them and I think it was in the coinsurance area, that is a major area, and we are just not sure what will come out of the investigations.

We would hope that we have found with this audit most of the big issues other than the possibility of one or two of the big coinsurers going under again, but you just never know.

Senator PRESSLER. Mr. Chairman?

Senator CRANSTON. I have more questions, but it is time for me to yield to you.

Senator PRESSLER. I just want to get in a question or two for Mr. Bowsher. Your prepared statement, backed up by the recently completed audit, vividly describes the lack of financial control over the FHA programs, and you have recommended that there be a Comptroller for the FHA.

Why don't we have an Office of the Comptroller reporting directly to the Secretary for all of HUD? Isn't that a desirable structure for this and other agencies?

Mr. BOWSHER. We are advocating that for other agencies, Senator. We think there should be a chief financial officer in every major agency, and if you had the 20 largest agencies in the Federal Government, you would have 95 percent of the dollars of the Federal Government. I think that it is essential and I think it is one of the weaknesses.

I have told Budget Director Darman that I think it is one of the major weaknesses in the Federal Government. We don't have adequate systems and the accountability of the Chief Financial Officer.

Senator PRESSLER. You recommend a comptroller for FHA who I understand would report to the Assistant Secretary for FHA, is that right, or would he report to the Secretary of HUD?

Mr. BOWSHER. He would report to the chief financial officer of HUD and the Assistant Secretary.

Senator PRESSLER. Who is the chief financial officer?

Mr. BOWSHER. We would establish a chief financial officer at HUD and then a comptroller at FHA.

Senator PRESSLER. You would create two posts. Essentially, you would have a comptroller for all of HUD?

Mr. BOWSHER. Yes.

Ms. FITTS. Senator Pressler, if I might, it is very similar to any major corporation.

For example, let's take Exxon Corp. It would have a chief financial officer, and any subsidiary that they have would have either what is known as a comptroller or their own financial officer who would be accountable to the person, the president around the subsidiary, but would also be accountable and have to be compatible with the chief financial officer of the entire corporation.

Senator PRESSLER. This plan would establish two new offices, a comptroller in FHA and a chief financial officer in HUD.

Who performs those functions now essentially?

Mr. BOWSHER. There is an Assistant Secretary for Administration.

Senator PRESSLER. Who performs those functions?

Mr. BOWSHER. That is correct.

Senator PRESSLER. What would be the qualifications of the chief financial officer as compared to the comptroller at FHA?

Mr. BOWSHER. The chief financial officer would have to have knowledge of all of HUD's activities in addition to the FHA, and the comptroller of FHA would be responsible for FHA's operations. He would basically be controlling FHA's four funds.

As far as qualifications, they should be top financial people. In other words, they should be the people that could qualify for major corporations or any other major government corporation, and I think that is important. If you don't get qualified people in these positions, again you won't get the success that you have to achieve. Just creating a position doesn't do it. You have got to get the right people in there.

Senator PRESSLER. Are they hard to get?

Mr. BOWSHER. It is not easy to get, but I think sometimes it is achievable in government to fill the senior positions because of the challenge that these people will face.

I think where we run into trouble in government is getting the middle management in place and retain them because of the salary structure.

Senator PRESSLER. Thank you, Mr. Chairman.

Senator CRANSTON. I think it is appalling that when Congress asks important questions about the performance of HUD programs we usually get the response that the information isn't available. At least that has been the situation in the past.

In an age of advanced information processing, that is really unacceptable. Billions of dollars are flowing through FHA each week. The report of those losses—these losses raise again the need for

complete, accurate, timely data. HUD certainly should be accounting for program and financial data at a very minimum by program, by region, and periodically throughout the year.

How else can we track what is happening, what is going wrong, who is doing well, who isn't, what policy changes are needed?

So to what extent are HUD accounting systems able to do that now and how bad are things in this regard?

HUD ACCOUNTING SYSTEMS

Mr. BOWSHER. That is one of your major areas of problems, Mr. Chairman.

In other words, the systems are not able to provide that information, and they should, absolutely, for the Congress, but also for the leaders of HUD to know where things stand.

That is part of the plan that has to be initiated and has to be carried out successfully if you are going to know where things stand.

Senator CRANSTON. What should be done and what is being done to correct this failure?

How long will it take to get acceptable accounting and control procedures in place, and is there anything Congress should be doing to speed things up?

Mr. CRAREN. There is a staff in place right now that handles FHA accounting functions. I think establishing a comptroller that would take charge of that staff would be essential.

I think the systemic problems are big ones. It will take a while to develop an automated system that will give you timely and accurate program data. It is not an easy problem, and quite frankly, my own opinion and my observations—you could ask the Federal Housing Commissioner—but they had to devote so much time to various problems that have cropped up that they haven't been able to devote a lot of attention to it yet in terms of developing program level data.

Senator CRANSTON. Do you want to comment, Austin?

Ms. FITTS. Yes, Mr. Chairman, thank you.

I believe I said in answer to one of Senator Pressler's questions that one of our first priorities was long-term personnel development.

I would have to say up there, if not second, is management information, the data that we have needed. I know you feel that it is very frustrating not getting the data when you ask me. I know it is terribly frustrating when I ask the people who work for me and they don't have it or they won't give it to me.

Program by program, as we have gone through our review, we have tried to define what data we wanted, and we are working on getting it, but it is an absolutely unacceptable situation, not just the financial accounting but many other kinds of necessary management information.

I would like to point out that Secretary Kemp did testify recently on expiring contracts in front of Senator Mikulski's committee and spoke about task forces we are doing on a comprehensive agency-wide management information study to determine exactly what we do need by area, and this would include FHA.

I should say again, as I have said before, however, to do some of these and to implement them on a timely basis will be very much affected by the response within the administration and here in the Congress to many of the reforms that we are hoping to come forward with in the near future.

So your support there would be very helpful on this issue.

Senator CRANSTON. I know you recognize the unacceptability of the present situation, and we are counting on you to get the remedies in place.

Mr. Craren, you were the project leader of course for Price Waterhouse. I understand that you did an outstanding job.

Would you please explain briefly the major elements of the project, what were the most important and the most difficult tasks that had to be carried out to produce these financial statements?

Mr. CRAREN. I thank the chairman for his kind comments. I would say that it was a challenging job for a lot of the reasons that have come out.

We have trouble knowing where the losses occurred and therefore trouble answering a lot of your questions today. I think the major elements as it progressed and as the situations got worse over there, at least publicly, is that we went through program by program, with a lot of help from the new administration in HUD, and tried to identify every possible problem we could find with respect to potential losses, and even after having done that, we were still uncertain, and that was a very time-consuming effort, and we found losses and financial problems in a number of programs.

Senator CRANSTON. You carried out the project through a change of administrations, and I know that that didn't add to the ease of the task.

What support have you received and what support are you receiving from the top manager of HUD, or what did you receive when he was—when Secretary Pierce was the head of HUD?

Specifically, to your knowledge, did Secretary Pierce ever express an interest in this major audit and the financial problems that it was uncovering?

Mr. CRAREN. To my knowledge, no, Secretary Pierce did not express an interest in our audit.

There was a perceptive increase in interest when the new administration came in. I think that was apparent to us from the Secretary's level and particularly the Assistant Secretary's level, and it certainly made our job much easier. There was much more of an interest in the financial soundness and the financial activities of the FHA with the change in administrations. I think that is correct.

Senator CRANSTON. So Pierce displayed no interest?

Mr. CRAREN. None to my knowledge.

Senator CRANSTON. Did you try to discuss the project with him?

Mr. CRAREN. We were dealing mostly, Mr. Chairman, with the Assistant Secretaries, or trying to, of Housing and Administration.

Senator CRANSTON. Did you try to get at Pierce?

Mr. CRAREN. We did not, no.

Senator CRANSTON. What effort did you make to work with other top officials in the last administration, and what was the response of FHA Commissioner Tom Demery?

Mr. CRAREN. As a routine part of any audit, we have to ask upper management to sign and represent that they have given us all of the accounting records that they know of, no violations of laws or anything that they haven't told us.

In the case of the prior administration, we had to get that representation from the Federal Housing Commissioner at that time as well as the Assistant Secretary for Administration at that time. While they did sign the letter, they did not at any time express an interest in meeting with us to discuss its contents.

Senator CRANSTON. So you did not get help from the people below Secretary Pierce?

Mr. CRAREN. We did try to contact them. They were told to us to be the responsible officials, and we were not able, although they did our representation letters.

Senator CRANSTON. Specifically, what about Assistant Secretary for Administration Judy Tardy? Was she helpful or interested?

Mr. CRAREN. Her staff was participating with us, and I would say that her staff was helpful. The Assistant Secretary for Administration at that time was not directly involved with us, nor did we ever have a meeting with her.

Senator CRANSTON. Did Deborah Gore Dean show any interest?

Mr. CRAREN. Not to my knowledge, no.

Senator CRANSTON. Who were the highest ranking officials who showed an interest in the study?

Mr. CRAREN. The highest ranking official was the Director of the Office of Finance and Accounting, who is a career civil servant, and I want to say that they were operating under a very difficult circumstance, set of circumstances, and I think, all things considered, did a fine job. I don't think that there was much interest in a financial audit at the time.

I don't think it was a perceptive trying to keep us out as much as they didn't really have much interest in what we were doing.

Senator CRANSTON. In good part, the political appointees didn't pay much attention or didn't display any particular interest?

Mr. CRAREN. I think that is correct, yes.

Mr. BOWSHER. If I could add one thing, Mr. Chairman. That is that it was Ms. Tardy who was the one that we finally sold the idea of getting something done as far as improving the systems. She was the one that agreed to start the audit work in 1987.

I think Tom is describing the fact that once we got started, we worked primarily with her staff and not with her, but I do give her credit for being willing to do something.

We were never able to deal with the Housing people because they were turning over so fast.

Senator CRANSTON. What has been the response of the present management team at HUD?

Mr. BOWSHER. Very good.

Mr. CRAREN. Very positive. It is helpful to us—it is very helpful to us if somebody with more detailed knowledge of how it operates expresses their problems to us and tells us—explains potential problems. It makes our job easier, and I think that is why the contact that we have had with the new team has been so essential and important to us.

Senator CRANSTON. What dc you see as the value of the audit effort that has been underway, and what will you be doing to use this information to build in the future?

I direct that to you, Austin.

VALUE OF HUD AUDIT

Ms. FITTS. It is very important to know where you are before you can start to put together any reforms or strategic plan.

Just to give you a little anecdote and also to compliment the efforts of GAO and Price Waterhouse, I had my Special Assistant Russ Davis lead an effort to compile every Inspector General report, every internal control, every GAO report, and every report, every press clipping, and every rumor in the building of any problem and make a complete compilation of every problem that we either had, had had, or might have, and when I first met with GAO and Price Waterhouse, I gave it to them, and they came up with two that we didn't even know about. I couldn't believe it. I thought we had found everything.

What they have done is that they have given us the comfort of really knowing where we are and helping us prioritize the problems, where the losses are coming from, the extent to which we can predict where future losses are coming from, or certainly what areas we need to study to determine what needs to be done.

I can say that that effort has saved us an enormous amount of time. If we were coming in 2 years ago without this work being done, we would be 2 years behind the curve.

So we are now operating with an extraordinary amount of the most critical information that we need to solve the problem, and I cannot thank them enough.

Mr. BOWSHER. Mr. Chairman, if I could just add to that.

I think Mrs. Fitts put her finger right on the issue. If we hadn't had the financial audits, it would be another 2 years, practically, before we would know where we were standing. So we would be into 1991.

When I met with Secretary Kemp, I compared this to the New York City fiscal crisis in the middle of 1975, where it took us several weeks to try to sort out their financial situation and then about 18 months to get the systems in to know what was happening on a monthly basis. In the middle of the 1970's, we did not have audits of any of the large cities in this country or any of the States, and today, based on the legislation that the Congress passed, we have audits of all of the major cities and will soon have all of the major States under an annual audit.

These large government entities know where things stand as a result of these annual audits. That is what you get out of an annual audit—Where do you stand financially?

Senator CRANSTON. Mr. Craren, I notice that the last administration's report for fiscal year 1988 showed a total FHA loss of $857 million compared to your estimate that the loss was $4.2 billion. A big, big discrepancy.

The last administration showed FHA equity at a positive $2 billion compared to your estimate of a negative $2.9 billion, again a

huge discrepancy, differences of $3 to $5 billion. I mean, those are really pretty incredible.

From your intense work on the details, are you confident that differences resulted only from justifiable differences in accounting methods, or are you confident that the HUD management was reporting all of the losses and expected losses and they should have been aware of it?

Mr. CRAREN. I would say this. The adjustments that we proposed and came up with were the result of a lot of work on individual programs that revealed a lot of problems. So I guess in that regard, particularly with respect to coinsurance and hospitals, in which we did a very thorough review, no, the number did not consider those events.

I think our idea is to look not for the outlay of cash, but we are looking for the event that is going to trigger a loss, so that we can bring that to everybody's attention, and in that regard we look for trouble scenarios like the coinsurance programs or the hospital programs or excessive defaults in the MMI Fund to identify the differences.

But I think what I want to make clear is that it is not just an accounting method. I think what we try to look for is a real incidence of loss, something that is going to cause a loss at some point, the outflow of cash sometime in the future. So it is not just an accounting nuance. I think we are looking for——

POSSIBLE COVERUP?

Senator CRANSTON. What I am really asking—and let me ask it more directly—is there reason to believe that some problems or losses were being deliberately kept from view?

Mr. CRAREN. We have no evidence of that, no.

Senator CRANSTON. You cannot make a judgment on that?

Mr. BOWSHER. I will say this. Doing financial statements on a cash basis, you can easily do that, and we do it in the Government.

Senator CRANSTON. Easily do what?

Mr. BOWSHER. Hold back the recognition of loss. In other words, one of the problems—and I told this to Messrs. Brady and Darman when they came in last year as the Chief Financial Officers of the Federal Government is that you are inheriting a budget deficit that is really far greater than the official figures indicate. We closed out fiscal 1988 and had nothing in there for the problems of the S&L crisis, for the nuclear weapons plants, and some of these other problems that have all come cascading onto the Congress and to President Bush here in the spring of 1989.

Cash basis in budgeting and accounting has always worried me from that very point of view. You tend to hold back all of your problems until you have to write a check, and the truth of the matter is, you have incurred the losses and you should report them.

Senator CRANSTON. Austin, let me ask you the same question.

Do you have any reason to think that there was any deliberate effort to hold back information to cover anything up?

Ms. FITTS. I know of no sign that I have seen that there was a deliberate effort. What I will say is that I certainly have seen a cul-

ture at the agency where there is—how can I say it—where there is a reluctance to face losses in certain portfolios and a reluctance to look at things on an accrual basis because nobody wants to deliver the bad news. So certainly I think that I have seen a culture that has conducted business that way, which certainly has to change.

Senator CRANSTON. Thank you.

In the August hearing we were promised that the 1988 audit would be more extensive than the 1987 audit. We were told to expect an opinion on the financial statements, a summation of internal control problems, and an analysis of FHA's compliance with existing laws and regs.

Why were you not able to produce these important elements of your report, and when will they be ready?

Mr. BOWSHER. They really are just about complete, Mr. Chairman, and we will be able to produce them in the next 30 days. It just took us a little longer.

But I might point out that in my statement today you have a summary of all of the major internal control problems and the compliance with existing laws and regulations. It is just that we have not been able to finalize the details, but I don't think that you will be seeing anything major that we haven't talked about today. We will be able to produce those within the next 30 days.

Senator CRANSTON. The National Affordable Housing Act contains a provision that would move the arbitrary sale of non-FHA mortgage insurance to enable FHA to spread its risks more widely in the strong housing markets.

I want to emphasize to get us into the stronger housing markets. I want to have GAO work closely with the subcommittee to identify how various policy changes along these lines can be designed to strengthen the long-term financial health of FHA.

What is GAO doing to complete that analysis, and when will it be ready?

Mr. BOWSHER. I would like to ask John Ols down at the end of the table to answer that because he is our person in charge of that work.

Mr. OLS. We are looking at three proposals involving: No. 1, raising the ceiling, No. 2, lowering the downpayment, and No. 3, making greater use of ARM's. We estimate we will be done in about 5 weeks, and we will be glad to work with you and your staff and the committee members to substitute any kind of different proposals that might be considered. We have an economic model based on FHA records and other data. We have something like 6 million records that we are dealing with, and we are trying to look at various economic scenarios, including the current trend, the most optimistic trend, the pessimistic trend, and a superpessimistic trend of what will happen to the fund over the next 10 years by raising ceilings, lowering the downpayment, and using ARM's.

I think that we would say at this point that we would not favor lowering the downpayment. But we are looking——

Senator CRANSTON. You would not favor what?

Mr. OLS. We would not favor lowering the downpayment at this time, but we are looking at the movement of the ceiling and what

that will do to the solvency of the fund, which is our main interest, and we will be coming back to you within the next several weeks.

Senator CRANSTON. We have questions about changing the downpayment, but I feel that we should give serious thought to lifting those ceilings in a way that will strengthen the fund.

It was indicated in the debate that we had in the Senate the other night that there is quite a bit of misunderstanding and I think quite a bit of misinformation about how lifting the ceilings would divert attention from those who need help more in adequate recognition of how we might strengthen the process by having some people who are better credit risks involved in the FHA program.

I hope you will be looking, Austin, very hard at that particular issue, which will come up again fairly soon. It will be dealt with in conference soon, and if HUD can reach a view on that and be helpful in that respect in finding the best possible solution, I think it is a very important early contribution that you might make.

This has been a painfully revealing examination of the state of the FHA funds for all of us, but we cannot wring our hands about the past. We must find solutions for a turnaround.

I appreciate your testimony. Is there any additional information that should be placed on the record to give a full and balanced picture of this important report?

Mr. BOWSHER. No, Mr. Chairman. I think we have had a very good discussion here about the problems and what the issues for the future are, and let me just ask my team.

Is there anything else to add?

Mr. DUQUETTE. Nothing new, Mr. Chairman.

Senator CRANSTON. I would like to ask you one more question, Austin, on the general housing legislation situation.

We have been eagerly awaiting the release of the administration's legislative proposals for reform of FHA. We are proceeding on our package of reform ideas and also on legislation, as you know, in the whole housing field.

What is the current timetable for the administration's proposal, both for reform and for housing programs?

As you know, a Democratic task force has been created. I am chairman of that task force, and part of the reason for doing that, frankly, was just to stimulate a response from an administration that hasn't yet been able to respond. I know that you and the Secretary are doing your best to formulate a policy, and I think the problems lie elsewhere, not in HUD, but we do need your position on both as soon as possible so that we can act in tandem to the best of our ability.

So we want them, and when are we going to get them?

Ms. FITTS. First of all, I want to thank you for always asking me the easy questions. The Secretary had me working nights and weekends, and he is frustrated because he cannot find some other time for me to work on some of this stuff.

But let me say that the Secretary set out his objectives, his six objectives, very clearly when he came to the agency, and we went over them in testimony the last time. He has said continually he has come to the agency to do housing and not reform.

What is unfortunate is the extent of the problems have been far greater than anyone, particularly the Secretary, anticipated, and so we have had to concentrate on the reforms simply because we cannot ask the American taxpayer to invest in housing through the agency until we get that done.

However, nothing is more important to us than facing the numerous very, very serious questions that face this Nation and this administration in the area of housing and particularly to achieve the Secretary's objectives, which are still very much forefront in his mind, and we will be doing that as quickly as is possible, as the reform package is over, and since I control nothing in that process, I cannot give you a good feeling as to time, but I assure you that the Secretary—the Secretary's heart is very much "as soon as possible."

Senator CRANSTON. We want to move legislation this fall if we can in this year. It will be difficult to do if we don't have things figured out by HUD. I know that it is not all within HUD where the decisionmaking has to be made.

I do want to ask one other question. A final item on your chart is "Improve Congressional oversight."

What do you suggest in that area?

SUGGESTIONS FOR IMPROVING CONGRESSIONAL OVERSIGHT

Mr. BOWSHER. What I suggest, Mr. Chairman, is that an annual hearing be held based on the annual report of the Secretary of HUD. This is what I am going to recommend to the other oversight committees, too.

Right now you have annual reports coming over to the Congress that are about an inch thick and lots of statistics in them, but you never have a hearing, and most people don't read those annual reports. I think that the big effort should be made to have an annual report that has all of the important issues—what can be accomplished this year, what needs yet to be accomplished; in other words, going up to the first bullet of the chart, how are you doing against the milestones of your management plan and your weaknesses?

A few years ago the Congress passed legislation in the Federal Managers' Financial Integrity Act which requires an annual statement regarding where things stand on internal controls. That should all be wrapped into the annual report. If a hearing could be held, then I think we would have better oversight over how well the programs are working and how well the departments are on top of their programs and the financial assets and operations of those programs.

I think it should be done on an annual basis. You can wrap the financial audit right in as part of it all.

Senator CRANSTON. Thank you all very much. You have been very helpful.

We stand adjourned.

[Whereupon, at 11:55 a.m., the subcommittee was adjourned.]

[Additional material supplied for the record follows:]

STATEMENT OF BENTON MORTGAGE COMPANY

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

September 27, 1989

Benton Mortgage Company and its principals have been involved in financing low and moderate income housing projects for over twenty years. Six of our 53 employees were previously employed by HUD, and two of them have been in the field for over 25 years.

We are proud of our contribution in financing apartments for low and moderate income families. Fred Benton has been a pioneer in providing financing for public housing under the old Section 23 leased housing program. We were one of the first underwriters to provide tax exempt bond financing for Section 8 projects on an uninsured basis; Fred Benton was one of the architects of the mechanism used to combine tax exempt financing with FHA insurance.

All in all, we have underwritten more than 300 tax exempt multifamily bond issues; 178 of these financed Section 8 projects. In 1979, the predecessor of Benton Mortgage Company began acting as an FHA mortgagee; in 1985, Benton Mortgage Company was approved as an FHA coinsurer for both the Section 221(d)(4) and Section 223(f) programs. In 1989, it was one of the first coinsurers to be approved to finance nursing homes under the Section 232 program. To date, Benton has closed approximately 150 coinsured loans, with a total loan value in excess of $640 million. Approximately two-thirds of these loans finance projects for low and moderate income families. The entire value of Benton's loan and bond portfolio is in excess of $3 billion.

Benton is also an approved GNMA issuer. In 1988, Benton was one of the country's largest issuers of GNMA mortgage-backed securities for multifamily housing.

We were also one of the original 16 lenders selected by the Federal National Mortgage Association to participate in its Delegated Underwriting and Servicing ("DUS") program.

Benton has always been well respected in the industry. Until earlier this year, Benton had never received a serious complaint on account of its extensive activities from any customer, program participant or regulatory body. We had always ascribed our success to our ability to combine creativity with prudence, and to hire well qualified, experienced personnel.

It should also be noted that Benton has never made any claim on the FHA insurance funds on account of its coinsurance activities. Its loan portfolio is secure (only one project is currently in default), and its financial strength is above HUD's currently required levels for coinsurers.

Benton Mortgage Company believes that FHA insurance has an important role to play in the multifamily housing industry, both as a means of providing necessary credit enhancement (particularly when sufficient mortgage money is not otherwise available) and as a way to provide appropriate federal policy direction and implementation.

Benton believes strongly in the important role that FHA insurance can play in providing financing for housing for low and moderate income families. While HUD, over the past several years, has not appeared to favor a special FHA role in this regard, Benton takes a more traditional position on this subject. It is in part for this reason that Benton--alone among the HUD coinsurers--has chosen to devote a substantial portion of its efforts to providing financing and refinancing for subsidized projects.

With all due respect to the Department, Benton would like to suggest that HUD's institutional memory has failed it, and that there are very few people left who have had significant experience in combining FHA insurance with HUD subsidies. Yet it is in connection with this type of housing that the nation has its most pressing needs, and it is to this type of housing that the fully privatized mortgage industry has the least receptivity.

The coinsurance program provides HUD with an enormous tool for financing low and moderate income housing. The controls provided through the coinsurance program requirements go a long way towards assuring quality construction and appropriate maintenance and management. As Judith Truitt of the City of Jacksonville, Florida, pointed out in her testimony before this committee on August 2, there is growing concern about the durability of some of the "mom and pop" moderate rehabilitation projects. We agree with her assessment, and believe that you will find that the coinsured moderate rehabilitation projects will withstand the test of time.

In addition to providing financing for mod rehab projects, FHA coinsured loans can be successfully used to refinance existing subsidized projects. In some cases, this will actually reduce annual debt service costs (and hence subsidy costs) over the life of a loan. This would be the case, for example, with respect to projects built with Section 11(b) tax exempt bond financing during the early 1980s, when tax exempt interest rates hovered around 13% annually.

Similarly, in the right circumstances, FHA coinsurance can be utilized to bail out the FHA insurance funds through the creative refinancing of defaulted mortgages, either to enable them to avoid full or partial assignment to HUD, or to get previously assigned loans back into private hands. HUD has been considering this idea for some time now.

Lastly, in the right circumstances, coinsurance can be used to help put together a package of incentives to encourage owners to extend low income usage at their projects. This would be even more the case if coinsurance authority were expanded to cover the Section 241 equity loan program, which was created by the 1987 housing legislation, but has not yet proved workable.

Of course, there is nothing that can be done under coinsurance that cannot be done under full insurance, so the question must be asked as to why coinsurance is itself necessary. The answers have been given by many, and are always basically the same. Even when fully staffed, processing a loan through a HUD field office took too much time; two or more years was not uncommon in some offices, making the process frustrating, expensive and--except where a borrower had no other choice--non-competitive. As the number of FHA loans nationwide diminished, the problems grew even worse as existing staff became "rusty". As HUD staff turned over (the better personnel often leaving to take jobs with coinsurers), many HUD offices simply lost the ability to adequately process an insured loan adequately.

Under present circumstances, we believe that an attempt to restaff at the field office level would be extremely time consuming and very expensive.

Having said all of this, however, we agree that changes need to be made in regard to HUD's regulation of the coinsurance industry.

For example, we agree, and have long maintained, that the financial strength of the coinsurers should be increased, although we believe that requiring all lenders to retroactively apply new standards with respect to existing portfolios is unfair and discriminates against the most established coinsurers. We do believe that lenders should be encouraged to increase their reserves with respect to their existing portfolios, however, just as we have always maintained net worth in excess of requirements. We also suggest looking at the possibility of requiring that a portion of the annual mortgage insurance premium received by the coinsurer be required to be placed in a loan loss reserve. Indeed, in the Section 221(d)(4) and 232 programs, we believe the amount of the premium could be increased.

In addition, we have found that our portfolio has been strengthened as we have gained experience and staff, and that our most recent loans are the strongest we have made. From this experience, we conclude that HUD should exercise substantial oversight for start-up lenders, conduct regular monitoring reviews and (here is a place we feel HUD is seriously falling down) provide for a mechanism to ensure that there is appropriate follow-up to the oversight reviews. Without this follow-up, the value of the reviews is quite limited.

We also believe that there should also be substantial limitations placed on maximum loan size for start-up lenders (and, on an individual basis, perhaps for all lenders), and restrictions or guidelines with respect to the amount of funds that can be loaned to one borrower.

We do disagree with what has been hinted at by HUD representatives, that one of the Department's goals is to encourage Wall Street to enter the program, at the expense of smaller, entrepeneurial lenders. With proper capitalization requirements, this should not be necessary. We do not believe there to be any better underwriting expertise on the tip of Manhattan than there is elsewhere in the country. We are concerned that program uncertainties have already forced a number of highly qualified lenders to withdraw from the program, or to reduce their activities significantly.

Several other points need to be made. For one thing, the importance of HUD augmenting and strengthening its own, central office personnel to deal with the coinsurance program cannot be overestimated. A strong cadre of professionals must be developed to: write program guidelines and give consistent and sensible responses to program inquiries; to process and review lender applications, and test cases, as well as other matters where HUD review is required; and to provide appropriate lender monitoring, oversight and follow-up. Appropriate staffing is not now in place. HUD should give first priority to this.

Similarly, certain program ambiguities must be immediately addressed. Benton has learned that, without appropriate guidance on certain topics, a lender is extraordinarily vulnerable to second guessing. We believe HUD rules should be made clear, even if this means withdrawing a degree of lender discretion. For example, HUD should provide:

> A clear definition of "identity of interest" between lenders and borrowers for the purpose of determining when pre-endorsement review by HUD is required. Present handbooks are totally inadequate.

A clear definition of an appropriate "identity of interest" contractor or subcontractor for the purpose of providing guidance for appropriate methods of cost certification and profit levels.

A clearer standard for the appropriate use of Section 221(d)(4) or Section 223(f) in situations where either may be arguably appropriate because of the nature of the rehabilitation involved.

A determination of whether maximum mortgage amounts should continue to be calculated differently for acquisition and refinancing transactions insured under Section 223(f) and--if it determined to retain such a difference--a rethinking of what qualifies as a refinancing to conform to general coinsurance standards. We understand that HUD is actively looking into this subject.

A mechanism on subsidized projects by which it becomes clear that the job of determining the amount of subsidy to put into a project is the responsibility of HUD, not a private party, and that HUD will make such a determination before the owner or lender expends a significant amount of time or money in connection with the development.

We have precise suggestions as to each of these items, as well as others, which we would be happy to share with the Committee.

We have only two other points to raise.

First, we would like to state for the record that we agree with a number of steps being taken by Secretary Kemp. We feel that the moratorium on new applicants was called for, that the interim procedures promulgated are by and large fair, and the changes being suggested for the program are at least on the right track. We agree with his decision to suspend the retirement home aspect of the program: Benton closed a couple of retirement home loans, and we put our own moratorium on our participation in that part of the program before Secretary Kemp did. We think he needs to be encouraged, however, to speed up the process, and to begin the job of augmenting program staffing.

As you know, on March 20, 1989, HUD's Office of Inspector General issued its audit findings that Benton had provided overly high mortgage financing on 14 coinsured projects. The projects were also receiving support from HUD under the now partially discredited moderate rehabilitation program. The effects of that audit have been devastating on Benton, its principals and employees.

As you are also aware, Benton filed a 2400 page response to the audit, setting forth our strong disagreement with the Inspector General's assumptions, methodology and conclusions. While we do not believe this to be the appropriate forum to engage in debate with the Inspector General with respect to the audit findings, we want to mention a subject increasingly dear to our hearts: due process.

HUD's ability to enforce program rules is crucial--but the process by which this is done must be fair. Benton Mortgage Company has been made subject to numerous audit findings, put on probationary status, and sent before HUD's Mortgagee Review Board. Final closing on three completed projects has been withheld, an unprecedented HUD action and one which we believe to be of questionable legality. For over six months we have attempted to engage in substantive discussion with HUD personnel on the audit findings, but have been continually turned down. We have no idea whether HUD's housing staff, for example, agrees with the findings of the Inspector General, or with us. It is our sincere hope that no other lender is caught in the Kafka-esque situation in which Benton finds itself, and suggest that it would be an appropriate function of this Committee, or some other Congressional oversight committee, to look into HUD's practice in this regard with some care.

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